ECONOMIC EFFECTS OF LONG–TERM FEDERAL OBLIGATIONS

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BEFORE THE

COMMITTEE ON THE BUDGET
HOUSE OF REPRESENTATIVES

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ECONOMIC EFFECTS OF LONG–TERM FEDERAL OBLIGATIONS

THURSDAY, JULY 24, 2003

HOUSE OF REPRESENTATIVES,
COMMITTEE ON THE BUDGET,
Washington, DC.

The committee met, pursuant to call, at 10 a.m. in room 210 Cannon House Office Building, Hon. Jim Nussle (chairman of the committee) presiding.

Members present: Representatives Nussle, Shays, Schrock, Diaz-Balart, Hensarling, Spratt, Scott, Cooper, Majette, and Kind.

Chairman NUSSLE. Good morning.

This is Budget Committee full committee hearing on "The Economic Effects of Long-Term Federal Obligations." Today we have two panels of witnesses who will give us an opportunity to delve into this in some detail and have had the opportunity to come before us before to discuss some of these kinds of issues.

Before we begin, I have a fun announcement for the record. My Chief of Staff and the Staff Director of the Budget Committee on the majority side, Rich Meade, had a baby just a couple of nights ago. He and his wife, Elizabeth, are doing fantastic and their little baby, Constance, is doing well. We want to congratulate them. He has a little leave of absence he is on right now, so you can all take advantage of me while he is gone because he is, as you know, my right arm and does a great job for the entire committee but particularly on the Majority side. We want to congratulate him on that new arrival and look forward to having a chance to congratulate him in person in September when we come back.

The second thing is, I just want you to know that the Budget Committee does have a Budget Committee library, and I would invite Mr. Spratt, as I have in the past, he may use that library whenever he would like. Just so we are clear on the record, if there is ever a need either during, before, or after—as I have invited him in the past—he may use those facilities as he sees fit in our spirit of bipartisanship in running the committee. We have a lot to argue about here, a lot of policy issues and things we will disagree on but thankfully we have run this committee in a good spirit. There is always good tension, but it is in a good way but we do have a library in case someone was wondering. It is not very big though. Where is it? I didn't tell you where it was but you are welcome to use it.

Mr. SPRATT. I am glad, Mr. Chairman, that we have a written and video record of that.

Chairman NUSSLE. Actually it is a good time to step back and what happened on the floor yesterday on both sides was a good way to kind of remind Members that we have a lot to discuss and a lot of big issues to deal with. There are ways to do it that are very appropriate and then there are ways that maybe get a bit out of line. We all can be part of the problem and part of the solution. In our committee, I think we have done a pretty good job of doing that and I hope that continues. I think that will. If Mr. Spratt and I have anything to say about it, we will.

Today the Budget Committee will hear from the Congressional Budget Office and our very distinguished Director, Dr. Douglas Holtz-Eakin. We welcome back to the committee for this purpose.

As a little background, our last few hearings we focused on how Congress spends trillions of taxpayers' dollars that we are entrusted with each year. Specifically, we focused on the problems associated with our current manner of spending. First, that we are spending too much and in many ways, too fast. As has been made clear through our waste, fraud and abuse hearings, in many cases it is spent very carelessly.

Second, we currently have a substantial spending induced deficit that all of us on both sides have agreed is unacceptable. So today's hearing continues our focus on reining in what may be an unsustainable rate of government spending from just a little bit different angle. Too often around here, we get so caught up in the issues of the day, we barely can see beyond the next week, what is the current amendment on the floor to cut or save a few million or billion dollars here and there. The problem with that is spending decisions Congress makes today have real consequences in the future. If we keep going like we are going, our so-called mandatory spending, that which is on automatic pilot, will become unsustainable. That is why we have asked Dr. Holtz-Eakin to be here today, to discuss some of these long-term implications for our ever growing spending obligations and their likely effects on the budget and the economy.

Let us take a real quick look at where we are today in relation to history. Until World War II, Federal government spending was less than 10 percent of the economy, or about $10 for every $100 of our Nation's gross domestic product. Today we have doubled that amount so that government spending now accounts for about 20 percent of the economy.

Now, let us look forward. According to CBO spending excluding interest will hit 21 percent of GDP by the year 2030. At that point, the economy will no longer outgrow spending. Spending, as I understand it, will outgrow the economy. Chart 42 as you see before us, our three largest mandatory programs, Social Security, Medicare, and Medicaid alone will claim as much from the economy, $20 for every $100, as the entire Federal budget does today. Just in the next 70 years or so, that is what we are looking at. The burden obviously gets greater after that.

A few may wonder why that matters. So what, why is this a particular problem? First, because Federal spending in and of itself adversely can affect the economy in an adverse way. All spending has to be financed somehow through taxes or borrowing. Either the tax increases are borrowing necessary to finance this growing burden would become too damaging to the economy and unacceptable to us politically.

Second, while we in Congress have already acted to grow the economy and reduce wasteful spending in government, these things alone will not be enough to solve the problem. I recognize that as much as we focus on waste, fraud and abuse, I have never suggested that in and of itself will get us back to a balanced budget and solve some of these long-term problems. It doesn't mean we shouldn't focus on them and we have here in this committee and have bee leading the way.

I recognize and I think all of our colleagues recognize that in and of themselves wasteful spending cannot resolve these issues, but there are additional steps we can take to alleviate these future problems. We are going to look at those today. The world has obviously changed significantly since many of these programs came into being, and it is long past time that we incorporate some of the medical and technological and slews of other advances that we have made in order to get these programs up to speed on quality and efficiency so that they will be around for generations to come.

I appreciate the work that you have done, Mr. Holtz-Eakin and your entire team in preparing for this hearing and preparing the information we want to consider today. I look forward to hearing your findings.

[The prepared statement of Mr. Nussle follows:]

PREPARED STATEMENT OF HON. JIM NUSSLE, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF IOWA

Today the Budget Committee will hear from the Congressional Budget Office on the economic effects of long-term Federal spending burdens. Our witness today is Dr. Douglas Holtz-Eakin, the Director of the Congressional Budget Office. Dr. Holtz-Eakin, welcome back.

As a little background, our last few hearings have focused on how we in Congress spend the trillions in taxpayer dollars we are entrusted with each year. Specifically, we've focused on the problems associated with our current manner of spending:

First, that we're spending too much too fast, and as has been made clear through our waste, fraud and abuse hearings in may cases too carelessly.

Second, we currently have a substantial spending-induced deficit that all of us on both sides of the aisle have agreed is unacceptable.

Today's hearing continues our focus on reigning in the current, unsustainable rate of government spending, but from a different angle. Too often around here, we get so caught up in the issues of the day that we can barely see beyond next week let alone the next generation. The problem with that is, the spending decisions Congress makes today will have real consequences for the future. And if we keep going like we're going now, our spending obligations our so-called mandatory spending will become unsustainable.

That's why we've asked Dr. Holtz-Eakin here to discuss the long-term implications of our ever-growing spending obligations, and their likely effects on our economy.

Let's take a quick look at where we are today, in relation to history. Until World War II, Federal government spending was less than 10 percent of the economy, or about $10 for every $100 of our Nation's GDP. Today, we've doubled that amount, so that government spending now accounts for about 20 percent of the economy.

Now let's look ahead. According to CBO estimates, spending excluding interest will hit 21 percent of GDP by 2030. At that point, the economy will no longer outgrow spending; spending will outgrow the economy. And as you can see by the chart by 2070, our three largest mandatory programs Social Security, Medicare, and Medicaid alone will claim as much from the economy $20 for each $100 as the entire Federal budget does today. And the burden only gets greater after that. Now, a few of you may ask, frankly, "so what?" "Why is this a problem?"

First, Federal spending in and of itself—as I hope Doctor Holz-Eakin will help explain—adversely affects the economy. All spending has to be financed somehow through taxes or borrowing. And either the tax increases or the borrowing necessary to finance this growing burden would be too damaging to the economy to be acceptable to any of us.

Second, while we in Congress have already acted to grow the economy and reduce wasteful government spending, these things alone will not be enough to solve this problem. Over the long run, the Federal burden will become too great for us to simply grow the economy enough or reduce waste, fraud, and abuse enough to be able to continue to sustain the larger programs.

But there are additional steps we can take to help alleviate the extent of future problems. We're going to have to take a look at the programs that are generating the most growth, but have not been significantly reviewed or updated in a long time Social Security, Medicare, and Medicaid, primarily.

The world has changed significantly since many of these programs came into being, and it's long-past time we incorporate the medical, technological, and slews of other advancements we've made to get these programs up-to-speed on quality and efficiency so they'll be around for the generations to come.

Finally, we need to look at how we can amend the budget process to better anticipate and provide not only for our mandatory obligations, but also for all of the other substantial costs we know we'll be hit with each year, such as establishing emergency spending reserves, and planning for ses on Federal insurance programs, and all of the other substantial spending.

I appreciate the hard work Dr. Holt-Eakin and his team have done in preparing this, and I certainly look forward to hearing their findings.

Thank you.

Chairman NUSSLE. With that, I would be happy to turn to Mr. Spratt for any comments he would like to make.

Mr. SPRATT. Thank you for holding this hearing.

Mr. Holtz-Eakin, thank you very much for your attendance and for the work you have put into it.

We too are concerned that future generations will pay a price for the unfounded commitments that this generation is leaving behind. I think there is one point on which members of this committee can agree and that is that the public debt we are accumulating right now is an inescapable, incontrovertible obligation of the Federal government. Just last week, we had the mid-session review delivered to us by OMB, a projected and accumulation of $1.9 trillion in debt held by the public over the next 5 years. Having made that projection, OMB still called for another $878 billion of tax cuts over the next 10 years in the face of its projection this could only worsen and add to the deficit.

These tax cuts are backloaded so that two-thirds of the 10 year revenue reduction falls in the last 3 years and more than a fourth falls in the last year itself. Our second witness will show how the cost of these tax cuts which make permanent the tax cuts of the last 2 years is more than three times as large as the 75 year actuarial deficit in Social Security expresses a percentage of GDP.

We have a simple chart to show that, table 10. The budget impact of the total tax agenda ranges from 2.3 to 2.7 percent of GDP. The present value of that over 75 years comes to about $12 [trillion]–$14 trillion. The actuarial deficit in Social Security over that period of years, present value, if we have enough money right now to put in the trust fund and make the system solvent would be $3.8 trillion. I mention that because as you add all these out year obligations over 50, 60, 75 years and put on the back burner GDP growth during this same period of time, they begin to get so enormous that they seem unsustainable in the chairman's word and impossible to obtain but in truth, the revenue base is being diminished right now to the point where if we had those revenues in the foreseeable future, there would be money there if committed to this purpose to make these programs solvent, Medicare and Social Security.

As both of our witnesses will make clear today: today's deficits have to be financed with tomorrow's taxes. Deficits are consequential, they have results, they have effects, especially today's which are the largest in history in dollar terms and among the largest as a percentage of our economy, measured as a percentage of GDP.

A minute ago, we had chart No. 9 and let us show it one more time. We cleaned this up a bit because there were too many things on this cluttered chart the other day but this shows our situation and over the last 10 years as graphically as anyone possibly can. The top line is outlays and as you will see, during the Clinton years, beginning in 1992, there was a steady decline in outlays, actual dollar spending of the Federal government to the point where it was about just over 18 percent of GDP, well below the peak of GDP level percentage of spending in 1983 which was about 23.5 percent.

Outlays steadily declined and at the same time, the revenues went up. There were tax increases, there were changes in the tax code that tilted the code more toward upper bracket taxpayers and as a consequence, as they prospered during the 1990s, they paid more revenues and the convergence of those two events led to the phenomenal recovery of the budget. The bottom line of the budget got better every year for eight straight years and then in the year 2000, we had a surplus which you see measured as a couple of percentage of points of GDP. In dollar terms, it was $236 billion.

In the year 2001, we began going down. As you can see, we now have the reverse of the situation we had in the 1990s. Instead of going up, revenues are coming down and instead of coming down, outlays are going up, just the reverse of what you need to balance the budget. As a consequence, we are accumulating debt that has to be paid and will have to be paid probably ahead of the claims of the programs Mr. Holtz-Eakin is going to describe for us today.

This is a matter of serious concern and I mention it because of all the things that will be on our table today as we talk about long-term obligations. The one that is most immediate over which we have most control is the deficit itself, the current deficits we are running. First in line in our obligations of the future for our children to pay will be the debt we are accumulating today. We shouldn't forget that.

There is a lot we can do to improve our budget practices, a lot we have to do to make our long-term mandatory spending obligations obtainable and solvent. One of the things we should do is not forget the elephant in the room called the deficit. If we stop feeding that elephant, we might accomplish something toward the goals we are going to be talking about today.

Mr. Holtz-Eakin, thank you again for your testimony. We look forward to it.

Chairman NUSSLE. When Mr. Spratt and I meet at the beginning of the year to talk about the hearing schedule, this is one of the hearings he suggested and I appreciate the suggestion. I join him in the need to discuss these long-term issues. We are glad you are here to help us do that.

We welcome you back to the committee and we will look forward to your testimony. Your entire testimony will be made a part of the record. I have asked them to turn off the clock because I know in 5 minutes, you can't talk about the long-term obligations of the country. I would ask you to elaborate and especially because there are fewer members here than may be typical, that way we can delve into some of these subject matters.

Your entire testimony is a part of the record, you may proceed as you wish.

STATEMENT OF DOUGLAS J. HOLTZ–EAKIN, DIRECTOR, CONGRESSIONAL BUDGET OFFICE

Mr. HOLTZ-EAKIN. Thank you, Mr. Chairman. Thank you, Mr. Spratt.

It is a pleasure to be here today to talk about a topic as important as the long run and the economic impacts of Federal obligations. I thank the chairman for the time to go through the highlights of my testimony. I will point out that those who know me well would suggest I can get through almost anything in 5 minutes but I will restrict my temptation to talk just way too fast and go through at a pace that someone can understand.

I really want to make five points today, and I will list them at the outset and go through them as time permits. The first is that when looking at the long run, it is appropriate to focus on spending. Spending in Federal programs is the best measure of the economic cost of those programs because it represents the diversion of resources from the private sector to the public sector. And that is the underlying economic cost of any Federal program—what you give up in the way of other activities in the private sector or between different programs within the Federal budget. The focus in the long run should be on how much is spent on alternative programs in order to measure their cost.

At the moment, we face two long run problems of somewhat different character. The first of them is a sharp increase over the long-term in spending from known sources, largely the entitlement programs that have been discussed in many places and which I will return to, and the second is the ongoing unknown commitments of the Federal government that come from the fact that many Federal obligations are not accurately represented in the budget. Programs such as insurance and credit guarantees represent obligations of the Federal government to transfer resources to liquidate those obligations and their true economic cost is not accurately represented. So they are unknown in the long-term as to their magnitude.

Since neither is well represented in the budget, it would be useful to move in a direction that did more accurately reflect the economic costs. The general principle that one should aim for in doing that is to represent in the budget the present value of the economic cost of an obligation when the government has firmly committed to that particular program or activity. I can come back at the end in the question and answer period to describe some of the difficulties in actually putting that into practice but as a principle, it strikes me as one that would enhance the comprehensiveness of the Federal budget and more accurately represent the economic cost of the different things the government does.

Let me first lay out some of the boundaries of the testimony. By focusing on the long-term and focusing on costs, I want to make it clear that Federal programs are created for the benefits they provide to American citizens. The budget is present to reflect the cost of those programs. By focusing on the budget, my testimony will focus on costs. I don't mean to do that in denial of the benefits of these programs but in order to more accurately compare among programs, it is important to have good measures of cost so I am going to focus on costs.

As I mentioned, the key issue in measuring costs is to look at the opportunity costs. What has the Nation given up by choosing to devote resources to a particular government program. This is not a deep or complicated concept. It is the concept that everyone uses in everyday life when deciding between buying a new car or choosing to go on vacation. The genuine cost of buying a car is what you give up, the vacation at the beach, and the valuation that one attaches to that particular decision is the opportunity cost, what is sacrificed by choosing to buy a car.

That economic jargon suggests that in moving to better comprehensive Federal budgeting, all Federal programs should be represented be their economic cost. First, this would allow programs to compete on an equal footing, and second, it would allow a better comparison between the costs of programs and the benefits of the programs so as to undertake only those activities that the Congress decides have value sufficient to overcome these costs.

A question that arises in conventional discussion of the cost of the Federal government is. What about taxes? Many people would automatically associate taxes as the cost of the Federal government. Over the long-term, it is appropriate to focus on spending because this spending will be financed one way or another. It may be financed by taxes. Alternatively, it could be financed by debt issue but the issuance of debt is essentially the decision to defer the raising of taxes until some point in the future, at which time the debt interest and principle will have to be paid off. So over the long-term, recognizing that spending is recognizing the commitment the Federal government has made for resources—and the tax-versus-borrow decision is a form of financing that logically comes second.

If one was setting out to design the activities, I think the first thing you would do would be to decide what was it you wanted to do and then figure out the form of financing second. For that reason, I think it is appropriate to focus on spending. In doing that, I commit a slight professional malpractice because it is widely recognized that in addition to the direct spending costs, the dollar resources taken from the private sector and brought to the public sector, the use of taxe—versus debt—has indirect costs often referred to as the excess burden of taxes. Those indirect costs are the costs the taxes impose on the economy by changing peoples' decisions for purely tax based reasons.

In the absence of taxes, people would pursue the highest value activities on the basis of their desires and what things cost. In the presence of taxes, you distort those kinds of decisions and have people pursue things for strict tax advantage. That is an extra cost associated with running Federal programs. A similar cost arises in using debt finance to run Federal programs.

I am going to defer those costs for two reasons. One, I think simply getting an accurate measure of the opportunity costs, the resources, is a very good start in pushing the budget to a more comprehensive framework. Two, there are very difficult issues of practical implementation there that I think outweigh the benefits of bringing those indirect costs in to the budget.

In the testimony, I outlined that the essential message here is that there is no costless spending, that there are finite resources. If they are devoted to public programs, they are not available for other uses, and I took some time in the testimony to identify some tempting situations in which you might think there was costless spending, ways in which one might think perhaps a dollar of Federal programs might not cost a dollar because there really were unused resources that were available, perhaps because of a business cycle decline or something like that.

What I want to do is put that aside. We can go through that in more detail, but I think those are illusory, and it is best to do budgeting under the framework that assumes there is a genuine opportunity cost for each dollar put into a Federal program.

Sometimes that attempt comes in the form of regulations where one attempts to move resources from one activity to another without actually putting anything in the budget, simply by using regulatory fiat. I want to commend Congress for recognizing that indeed this has the same economic burden as using a budget item to move the resources. Something like the Unfunded Mandates Reform Act of 1995 brought into the budget process a recognition that regulation is an alternative form of diverting resources and that over the long-term, this will have the same economic cost. That represents the kind of step in the right direction toward the more comprehensive budgeting that is desirable.

Let me spend a couple of minutes on each of the two major points and begin first with the known long run consequences which face us.

I have shown on the chart quite vividly, the long run trajectory of the entitlement programs. CBO has projected that if one looks at the built-in tendencies for spending on the entitlements—Social Security, Medicare, Medicaid—makes some judicious assumptions about other noninterest kinds of spending, then one will see a rise in Federal spending as a fraction of GDP to a level of 28 percent by 2075. And if one looks within that long run pattern, one can see there is a sharp rise first in Medicare, which rises most quickly earliest, and as well in Social Security in the near term as we move toward 2075.

Those represent obligations that if the government were to meet would exceed the previous scale of Federal government as a fraction of the U.S. economy and would entail sacrificing private sector activities.

One thing I want to point out is that in the current budget process, these costs are not well represented. An example of that is that a 10-year budget window fails often to capture the nature of the commitment made when expanding an entitlement program. There has been lots of discussion in Congress about the proposed Medicare prescription drug benefit, with a number typically put out at about $400 billion over 10 years.

I hasten to point out that if one goes to the next 10 years and takes another 10 year budget window, the cost of that prescription drug benefit is likely easily to exceed $1 trillion and may approach $2 trillion. So in moving the budget to a more comprehensive appreciation of the commitments of resources in some cases, it is necessary to look farther than a five or 10 year budget window.

In addition to entitlements, we face perhaps large obligations in the areas of defense, where over the past 3 years, we have seen about a 50 percent rise in military and defense spending. And we face as well possible increases in areas of homeland security and environmental obligations, some of which are related to defense.

I think the first long run problem which will have economic consequences is the known spending in these entitlement programs and some of the potential expansions of them. The second problem is that the current budgeting practices don't fully reflect the economic costs of Federal activities. I think it is important to so do, as I said at the outset, because it would facilitate comparisons across programs to put them on equal footing in making decisions. It would facilitate comparisons between benefits and costs so that one could decide which things actually passed the test of devoting resources to the highest value, and it would put things on an equal footing between the public sector and the private sector so that decisions to actually use more resources for public programs could be made in a clear and level fashion.

Congress has taken steps, as I mentioned, to do this better. An important step was the Credit Reform Act of 1990, which recognized that the act of providing subsidies to credit in the economy was an act of diverting resources; it brought those costs into the budget in a fashion that I think has improved the decision making capabilities—just as I think the Unfunded Mandates Reform Act has contributed to that kind of decision making.

There are still some shortfalls in the budget, and there are many ways one could imagine bringing resources from the private sector into the government. One could bring economic and budgetary advice from the private sector into the government by paying the CBO director an appropriation, which is in fact how Congress does it. There are many other ways one could imagine as well. One could provide the CBO Director with a subsidy on a mortgage and rather than an appropriated salary. I think a 5 percent subsidy on a $3 million home somewhere in the nice suburbs of Maryland would probably have induced me to come to the CBO as well. Those are the same economic resources being moved from one place to another. They should be represented in the budget in a level fashion.

Anyone who knows me knows that no mortgage bankers would give me that kind of mortgage: they would be out of their minds. So I might ask you to guarantee that mortgage, and the mortgage guarantee would have the same economic impact as the subsidy would. Each should also be presented in the budget in an even fashion. To the extent that I require capital equipment that isn't paid by appropriation, one might imagine leasing it when it is highly specialized forecasting equipment. That lease is a de facto purchase of the equipment, and it should be represented in the budget in a perfectly level fashion.

If Congress did desire to in perpetuity commit to having such direction, and I encourage it in this regard, the commitment should be placed in the budget with the present value; economic and budgetary advice would always be in this form. I don't want this to create the possibility that CBO might get closed, but in the absence of such a commitment, if you leave open the option to choose another avenue, then it is not appropriate to put the present value in the budget. Finding the dividing line between when that commitment is firmly made and when Congress has retained the option to modify a program is one of the hard things about implementing an opportunity cost-based approach to comprehensive Federal budgeting.

I will leave it to your imagination to envision other possibilities for combinations of ways to move economic resources. My major message is that doing them all in a level fashion will make it clear the kinds of commitments that are made, make it easier for Congress to choose among programs and that indeed, in doing that, there are lots of opportunities. There are places where we could improve the Credit Reform Act to more accurately represent the risks present in the market; there are places where we could improve the budgetary treatment of insurance programs. An example that comes to mind is the PBGC. For years the PBGC has appeared to be a benefit to the budget where premiums came in without any recognition that behind those premiums was a liability, a contingent liability for something on the order of $2 trillion worth of pensions for 33,000 plans. It is more appropriate to reflect that potential cost than to pretend an insurance program is a program that raises money.

In public and private partnerships where the government has a controlling interest and has provided equity, it is appropriate to have those in the budget so that it is clear that this is not a private sector activity, that the resources came into the government and were devoted to this particular activity. Programs such as Amtrak come to mind in that regard. There are many others as well.

I will close and be happy to take your questions by pointing out that this is not an easy task. I think it would be a useful one for Congress to point toward a more comprehensive and even budgeting of all Federal activities. There are many difficulties of implementation, among them deciding how firm a commitment exists; and when a firm contractual agreement exists, it is appropriate to put the present value benefits in the budget.

One can imagine a college program in which students sign up, sign a contract, agree to maintain good academic standing and are promised 4 years' worth of college tuition as a result. It would be appropriate there to put the entire cost on the budget at the time of that contract.

Alternatively, you could imagine no such guarantee year by year but rather an annual appropriation in the spirit of the Pell grants, in which case it would be appropriate only to put the first year's funds in the budget because the commitment did not exist four years into the future. There are many gradations in between. One example that comes up right away is the entitlement programs. In the past these programs have been modified. I believe it is fair to say that Congress retains the option to modify them in the future, so I am not one of those who would be in favor of immediately booking the present value of such obligations as a liability on a Federal balance sheet. Instead, I think it is better to provide supplementary information that informs the Congress about the nature of the scale of these activities. That supplementary information could be as simple as charts that show the dramatic rise in the ultimate share of GDP that they would command, and CBO has begun to work on the capability to provide 75 year estimates of impacts of changes in entitlement programs. We are working with you in the Congress on the issues of credit reform and would be pleased to work with you in any other areas you might think would be appropriate.

I thank you for your patience and for the time to walk through what I think are the key points. I would be happy to answer your questions.

[The prepared statement of Mr. Holtz-Eakin follows:]

PREPARED STATEMENT OF DOUGLAS HOLTZ-EAKIN, DIRECTOR, CONGRESSIONAL BUDGET OFFICE

Mr. Chairman and members of the committee, I appreciate the opportunity to discuss the adequacy of budget measures in portraying the Federal government's long-term fiscal outlook. The Congress adopts Federal programs to provide benefits to U.S. citizens and uses the budget to indicate the costs of those policies. In preparing for this hearing, I have been especially mindful of the mission of the Congressional Budget Office (CBO)—to provide the Congress with objective information and analyses for budgetary and economic decisions. At the heart of that mission is CBO's responsibility to quantify the costs of Federal programs and policies.

With that objective in mind, and with the strong caveat that I will be speaking only about costs while ignoring benefits, I want to make the following points in my statement today:

- Over the long-term, the U.S. Government faces enormous demands for Federal spending, which are not adequately reflected in the budget.
- Every dollar of Federal spending has a cost. It makes no difference if the payment is charged to the general fund, a trust fund, or an enterprise fund; nor does it matter if the payment purchases goods and services, provides income support, subsidizes an activity, or liquidates a guarantee or an insurance claim.
- Government spending is usually a good measure of the cost of government to the economy—its economic cost—because that spending preempts the use of resources by others for other purposes. The dollars spent measure the value of forgone alternatives for the private sector and within the budget.
- The budgetary costs of Federal commitments should reflect their economic costs. Even though the government commits to future spending in a variety of ways, including social and other insurance, Federal pensions, credit programs, and the support of international organizations, all uses of funds can be compared in terms of their economic costs.
- Reliable, comparable, and comprehensive cost information for all Federal activities would inform Congressional decisions and align Federal spending with the value of alternative uses of those funds.
- It is timely to reassess the principles of Federal budgeting to better measure economic costs. CBO has begun to provide supplementary estimates of mandatory and discretionary spending, the effects of expiring legislation, the effects of risks on spending, and costs of Federal activities not currently shown in the budget.

Let me discuss each point in turn.

THE LONG-TERM OUTLOOK FOR GOVERNMENT SPENDING

It will not be news to members of this committee that the United States faces severe fiscal demands in the decades ahead. CBO projects that, on the basis of current rules for benefits, Federal spending, excluding interest payments, will rise as a share of national income from the level of roughly 18 percent in 2002 to about 28 percent by 2075 (see Table 1). Little disagreement exists about the cause of that situation. It stems primarily from Federal policies aimed at improving the well-being of retirees, the disabled, and the chronically ill.

Other commitments, such as defense spending, may also claim a substantial share of society's resources. Additional potential demands include the war on terrorism, homeland security, environmental cleanup (including that resulting from defense activities), and settlements of asbestos claims.

In short, the Federal budget faces known, growing demands that will absorb an increasing share of the U.S. economy.

In addition to those relatively predictable demands, the government faces significant fiscal exposures that are not fully counted in the budget, including those arising from its insurance and guarantee programs—as exemplified by the Pension Benefit Guaranty Corporation (PBGC), through which the government insures over $2 trillion in projected benefits in 33,000 defined-benefit plans. For years, the PBGC generated more money in premiums than it paid out in benefits, and the budget reflected that positive cash flow instead of the underlying liability. Currently, insured pension plans are underfunded by an estimated $300 billion, so the ultimate cost of pension insurance to the government could be significantly larger than current figures would suggest.

For many programs, the Federal budget fails to extrapolate costs over an appropriate horizon. While 5- or 10-year projection horizons may be adequate for some budget decisions, they are especially deficient when evaluating the implications of changes in entitlement programs. For example, the proposed Medicare prescription drug benefit is estimated to cost roughly $400 billion from 2004–13, but, under reasonable assumptions about future drug spending and demographics, costs would exceed $1 trillion and could approach $2 trillion during the following decade.

Thus, the United States faces huge fiscal demands in the coming years, yet the Federal budget does not adequately capture future commitments.

TABLE 1.—FEDERAL OUTLAYS BY CATEGORY, 1950 TO 2075

(As a Percentage of GDP)

Fiscal year	Social Security	Medicare	Medicaid	Social Security, Medicare, and Medicaid combined	Other spending, excluding interest expense	Total, excluding interest expense
1950	0.3	n.a.	n.a.	0.3	13.5	13.8
1960	2.2	n.a.	n.a.	2.2	14.2	16.4
1970	2.9	0.7	0.3	3.9	12.8	16.7
1980	4.3	1.2	0.5	6.0	13.7	19.7
1990	4.3	1.9	0.7	6.9	11.7	18.6
2000	4.2	2.2	1.2	7.6	8.5	16.1
2010	4.4	2.7	1.8	8.8	7.6	16.4
2020	5.4	3.6	2.3	11.3	7.1	18.4
2030	6.2	4.9	2.8	13.9	7.1	21.0
2040	6.2	6.0	3.4	15.5	7.1	22.6
2050	6.0	6.7	3.9	16.7	7.1	23.8
2060	6.1	7.7	4.3	18.1	7.1	25.2
2070	6.2	8.9	4.9	20.0	7.1	27.1
2075	6.2	9.6	5.3	21.1	7.1	28.2

Source: Congressional Budget Office.

Note: n.a.=not applicable.

THE ECONOMIC COSTS OF FEDERAL SPENDING

As a general rule, the best measure of the economic burden of a government program is its spending. Consider, for example, a discretionary program financed by annual appropriations. Spending by such a program diverts productive resources from private consumption or investment to government use. If the activity replaces private consumption with government consumption, the costs are felt in the present. If, however, the effect of government spending is to displace private investment, the cost is forgone growth in the capacity of the economy to produce—a loss that persists into the future. Federal financing of expenditures, either through taxes or borrowing, reduces the resources available in the private sector, and the people deprived of those resources bear the burden of government spending.

Resources are limited. The use of resources for one purpose necessarily denies them to others—a fact of life that is sometimes easy to forget. For example, much of the discussion about future spending for Social Security and Medicare has focused on whether revenues earmarked for those programs will be sufficient and whether their trust funds will become insolvent. Although those issues may be important, they should not distract from the more fundamental economic consideration: the resources expended on those programs must be financed either by taxes or by borrowing, which implies future taxes. Thus, that spending will be just as costly as any other Federal spending.

In economists' jargon, every dollar spent on a government program has an opportunity cost: that dollar is not available to be spent on something else. The cost, then, is whatever is forgone. When, as an individual consumer, I am deciding whether to buy an automobile, I am (at least implicitly) determining whether I would get more value using the money for that purpose than for any other. When, as elected representatives, Members are deciding whether to spend $100 million for a Federal program, they are making a similar determination: is that the best use for taxpayers' money, given the possibility of other uses? Even though most such legislative decisions are not directly tied to decisions about taxes, the result is the same: unless other expenditures are reduced, current or future taxpayers will be required to give up the benefits from their use of those funds.

A distinction is sometimes drawn between the economic costs of government activities in which the government directly purchases goods and services, such as military procurement, and other government activities in which the government transfers purchasing power to recipients, such as the Social Security program. In the first case, the government is causing taxpayers to have fewer resources at their disposal so that it can use those resources to purchase specific goods and services. In the second case, the government is reducing the resources available to taxpayers in general and is increasing the resources available to the program's beneficiaries but is not directly purchasing specific goods and services. Recipients can use the resources to buy whatever they want or save them for themselves or their heirs. In both cases, however, taxpayers are giving up control of resources. Whether their tax payments are then used by the government to purchase aircraft or by the recipients to purchase consumer goods or anything else does not affect the cost to the taxpayers.

Although I am stressing spending as a measure of economic burden, it is worthwhile to note an additional cost of public programs financed through tax revenues. The existence of taxes may change the behavior of the taxpayers in ways that reduce their well-being, a cost referred to as the excess burden of taxation. For example, a tax on wages may cause some people to work fewer hours or to retire earlier than they otherwise would have. A tax levied on a good or service will induce taxpayers to reduce consumption of the taxed item to avoid the tax. (Of course, in some cases, the tax is designed to reduce consumption, as with the taxes on alcohol and tobacco, because consumers may not fully cover the adverse costs of their behavior.) Taxes that distort economic decisions thus have two costs: the amount collected and the loss to individuals from induced changes in behavior. The latter cost, however, would be quite difficult to estimate, which suggests that focusing in the budget on the direct burden of government spending is the most valuable immediate objective.

NO FREE LUNCH: NO COSTLESS SPENDING

It is human to hope for magical solutions to thorny problems. Accordingly, policymakers sometimes encounter proposals for "costless" spending based on the existence of unused capacity, gains from public investment, or regulation. None of those lives up to the promise of magic, however.

When the economy is operating below full employment, the opportunity cost of government spending can be smaller than at full employment. For example, when there is large-scale unemployment, putting people to work on Federal jobs may divert few resources from other productive activities. The timing of such projects, however, is tricky. By the time they are launched, the labor market is already likely to have tightened. That is, over the long-term, the economy tends to return to full employment of its human, technological, and financial resources. For example, by CBO's projections, today's relatively high unemployment rate of 6.4 percent (as of June 2003) will gradually decline to 5.2 percent by 2007 and remain at that level. Therefore, to assume that the resources used for a government program otherwise would have been idle is not judicious.

In principle, one might also argue that Federal spending for investments would result in more resources for other uses, not fewer. That would be the case if the rate of return on the Federal investments exceeded the returns that could have been earned by taxpayers themselves. But that characteristic is rare for a Federal program. Many Federal investments substitute for state and local spending or private investments that would otherwise occur. In any event, only a small fraction of Federal spending is for investments. (The Office of Management and Budget estimates that outlays for major Federal investments, such as the acquisition of military equipment, research and development, and grants to state and local governments for transportation infrastructure and education, accounted for about one-sixth of total Federal spending in 2002.) The argument does not apply to the bulk of government spending, which goes to consumption, or to income transfers to support consumption, including those for Social Security, Medicare, and Medicaid.

Similarly, one might cite the social benefits effected by certain laws or regulations with low or no Federal costs. Through law and regulation, the Federal government frequently requires other levels of government and private entities to expend resources to achieve Federal policy goals. For example, the Federal government has enacted laws mandating that new cars meet certain safety and fuel-efficiency standards. Consequently, automakers' production costs and the prices that they pass along are higher, causing some consumers to seek alternatives to new cars, including keeping old cars in service longer or purchasing used cars (which, presumably, are less safe and less fuel-efficient). The benefits provided by regulation are no more "free" than those that derive from spending.

That economic fact has not been lost on the Congress. The Unfunded Mandates Reform Act of 1995 (UMRA) was enacted to focus attention on regulatory costs. One provision of UMRA requires CBO to estimate the costs of Federal legislation that would impose mandates on public- or private-sector entities. Such information aids the Congress by enabling Members to consider the costs of proposals beyond those currently reflected in the Federal budget.

Some proposals for "costless spending" that come before the Congress lack even the veil of legitimacy assumed from promising to use unemployed resources, invest in particularly high-return projects, or improve welfare through regulation. Those efforts to hide budget costs, sometimes referred to as innovative financing, and at other times as budget gimmickry, come in many guises, including public/private partnerships, government-sponsored enterprises, off-budget special-purpose entities, and directed scorekeeping.

A common method of hiding the cost of government is through "tax expenditures," by which the government selectively reduces tax liability to substitute for spending. They are employed to finance education, housing, and health expenditures; to provide assistance to particular industries; and to aid state and local governments, to name but a few uses. By appearing as reductions in receipts in the budget, they mask costs. But they have many of the same attributes as more spending, diverting resources from other uses in the economy and causing higher tax rates to make up for the reduced tax base.

The Relevance of Economic Costs to Public Policy

Policymakers constantly weigh the costs and benefits of proposed and existing legislation. Just as markets work best in allocating resources to their highest valued uses when prices reflect the true costs of goods and services, the Congress is best served when Members have the most comprehensive and accurate information about the costs of legislation. Moreover, because Federal budgeting affects the allocation of resources between private and public uses as well as among public uses, the relevant cost is the highest valued alternative to all other uses, private as well as public. All alternatives can be better compared when budgetary costs reflect economic costs.

Spending is a good measure of cost because it will have to be financed, at least eventually, by taxes. Thus, a guiding budgetary principle should be to recognize in the budget the amount of taxes that will be needed to finance a commitment. Further, at the point when the commitment has been made, its cost should be recognized in the budget, even if the spending will not occur immediately. Nevertheless, I acknowledge that it is sometimes difficult to distinguish exactly when a commitment to spend has been made and how durable that commitment may be.

While a one-time appropriation may reflect a commitment with clear timing, relatively few spending decisions are that straightforward. In fact, many programs that are nominally controlled by annual appropriations are ongoing functions'such as defense, transportation, and education—that the Federal government could reasonably be expected to continue, and baseline budget projections reflect that expectation.

The difficulty of determining the timing of commitments is illustrated by a Federal policy to provide financial assistance to low-income students enrolled in higher education. That policy might be regarded as a commitment to spend for students who are now eligible and for students who become eligible in the future. However, because the commitment is not contractual, the Congress retains the right to change the law defining eligibility or to substitute a different form of assistance. Clearly, the current program cannot be regarded as irrevocable; therefore, the present value of the assistance should not be recorded in the budget.

Indeed, for social insurance programs, it seems fair to say that although the commitments are clear in current law and are so reflected in baseline budget projections, the government has not firmly committed to paying the current level of benefits to all future generations. In other cases, such as loan guarantees and insurance, the government's commitment to spend may be contractual and firm, but the value of the dollar payments may be uncertain and difficult to estimate.

I suggest that the principle of recognizing the cost of commitments in the budget when they are incurred implies that the mere expectation of future spending is not sufficient to warrant recognition in the budget. The government's obligation in the future must be firm to justify including the costs for it in the budget today. However, I also suggest that the principle of being timely in recognizing costs in the budget never excuses an estimated cost of zero just because the amount is not yet certain.

ECONOMIC COSTS IN THE BUDGET: ACCOMPLISHMENTS AND CHALLENGES

The objective of recognizing economic costs in the budget reminds me of an exchange that occurred years ago between the chairman of a House committee and a representative from the administration, who was advocating the creation of a program. In answer to the chairman's question, "How much will this cost" the witness replied, "Do you want that in budget authority, outlays, or discounted present values?" To which the chairman thundered, "I want it in dollars!"

I sympathize with that chairman's desire for transparency and simplicity in the budget. When the amount of dollars spent adequately captures the economic cost of a Federal activity, as it does in most cases, we should look no further for an appropriate cost measure.

In spite of the efforts of many to improve the budget process over the years, much more remains to be done. Some activities currently classified as nonbudgetary, such as those of Amtrak, may be more appropriately considered within the budget. Similarly, other types of contract-specific activities, such as the construction and leasing of buildings for military housing and Federal offices, may warrant budgetary treatment that is different from the way they are currently handled. Federal exposure under insurance programs is another area in which the current budgetary presentation could be enhanced. Also, information about the long-range commitments for social insurance programs could be more prominent in budget documents.

BUDGETING FOR RISK

A particularly difficult and increasingly important issue is the treatment of risky activities like providing loans and guarantees, and insurance. Indeed, Federal direct loans and guarantees constitute an area of budgeting where the Congress addressed accounting shortcomings through passage of the Credit Reform Act of 1990. Prior to that law, both direct loans and guarantees were treated on a cash basis in the budget. For direct loans, cash flows in any single year consist of outlays for new loans and repayments for some outstanding ones. The net cash flow in any single year is a meaningless amalgam of the amounts of cash in and out. The cost of new loan programs is especially overstated on that basis because nearly all the cash flows are out in the early years. For guarantees, single-year cash flows are a mix of fee collections, payments for defaults, and inflows from recoveries. Before credit reform, the misstatement of costs for new guarantee programs was especially perverse because cash flows in the early years often were dominated by the inflow of guarantee fees, with few outlays for defaults.

Under the Credit Reform Act, the cost of a direct loan or loan guarantee is the net present value of all cash flows over the life of the loan, recognized when the loan is disbursed. Net present value is calculated by discounting cash flows with interest rates on Treasury securities of the same maturity. Credit reform was a much needed step toward getting the economic cost of credit programs in the budget, and it follows the principle of recognizing budgetary impacts at the time loans and guarantees are extended. In my judgment, the budget information now available to the Congress on the cost of credit programs is far superior to what existed before.

With the experience of the past 10 years or so, however, it may be time to revisit the credit-reform model and its application. One shortcoming of the current approach is that it appears to understate the economic cost of Federal credit programs because the discounting of expected cash flows at the government's risk-free borrowing rate ignores certain costs of risk. Private investors, by contrast, require compensation to induce them to bear risks that cannot be eliminated by diversification—for example, market risk. The compensation to investors for market risk comes in the form of an expected return that is higher than the rate on government debt that is used to value loans and guarantees under the credit-reform model.

Turning to other areas involving the Federal treatment of risk, I would point out that the current budgetary accounting for Federal insurance programs, such as deposit and pension insurance, still falls far short of the objective of assigning full economic costs to those activities. Currently, the costs of those activities are reported on a cash basis, which does not reflect the multiyear nature of the commitment. One result is that the programs report negative spending in most years, suggesting that they provide net income to the government, when in fact they represent a potentially enormous contingent liability. Consequently, alternative approaches may be needed to recognize the economic costs of insurance programs in the budget, perhaps building on the principles underpinning credit reform.

FUTURE DIRECTIONS

The line between concrete, and therefore budgeted, commitments and less firm spending plans is not always clear. For a commitment that is contractual, the estimated cost is its present value when the commitment is made. But for a commitment made under policies that are subject to periodic revision, like the major entitlement programs now fueling increases in spending, the economic costs for the entire future of the program should be recognized in the budget only to the extent that the commitment is not subject to revocation. For such programs, however, it is useful for the budget to include additional supplementary disclosures. Where the government's commitment to spend is very strong but not irrevocable or unalterable, determining the appropriate budgetary treatment for those programs will be difficult.

CBO's annual report on the budget and economic outlook already includes alternative projections for discretionary spending, as well as estimates for extending tax provisions that are scheduled to expire. Similarly, for the few mandatory spending programs (such as those providing aviation terrorism insurance or the Federal backstop for property and casualty terrorism risk insurance) that are allowed to expire under the procedures for CBO's baseline, the agency could report estimated costs under the assumption that the programs will not terminate as legislated.

CBO is developing the capacity to provide long-term projections for Social Security and Medicare to more accurately estimate future commitments under those programs. It will also use a long-term model as a basis for cost estimates for changes in those programs. In addition, I will soon become a voting member of the Financial Accounting Standards Advisory Board, which considers government standards for financial reporting with a view toward comprehensive disclosure of the costs of Federal activities. Further, CBO is expanding its use of techniques of modern financial analysis, which will enable the agency to better assess the risk exposure of the Federal government through its guarantee and insurance programs and public/private partnerships.

Such issues and developments, along with the huge impending demands on Federal spending, make it timely to reassess the principles underlying Federal budget accounting. Specifically, participants in the process need to renew their commitment to the objective of getting the most relevant measures of cost into the budget in support of congressional decisions.

Chairman NUSSLE. Thank you. That was very instructive, and we are already gaming how we can change your salary and benefit package up here in the next budget.

You made a point in your testimony and I just want to emphasize it because the chart you show I assume and I guess I want to understand this for the record, it assumes that nothing new by way of entitlements come on line. I assume in the Medicare portion of this slice on the chart, let me ask are you assuming the prescription drug benefit?

Mr. HOLTZ-EAKIN. No. This is an extrapolation of current law.

Chairman NUSSLE. So the prescription drugs is not in there. Therefore, I assume that no new entitlements, concurrent receipts or any other expenditures would be part of this curve?

Mr. HOLTZ-EAKIN. No.

Chairman NUSSLE. That gets me to the next question. From a budgetary standpoint as a way to solve this or resolve this, it looks as though, and I know this is based on a percentage of GDP so it doesn't show the true growth of these programs. Certainly it shows

Medicare is growing but it doesn't show the actual dollar growth. It shows its growth as a percentage of GDP. So it makes it look arguably a lot less than it would if you showed it on a dollar, on a nominal basis.

That is one thing I observe here and I am wondering would it be an acceptable budgetary method to try and bend the curve? What we are looking at here is fairly daunting but I would assume if you can start to bend the growth curve slightly in the first few years, it pays huge dividends in the out years. I know part of this is a political or policy decision we are just going to have to come to grips with but what number should we look at? What percentage should we try and strive for as we consider bending that growth curve and tilting it slightly less dramatic as it shows in the chart before us? What percentage should we look at? I know that is a discussion currently going on in the Medicare conference as an example to try and bend the growth curve in order to accommodate some of these new benefits?

Mr. HOLTZ-EAKIN. The percentage toward which Congress aims is ultimately a policy decision. I can give you some guidance on both the numerator and the denominator of that particular curve. In the denominator, that is growth in GDP and to the extent that in meeting other policy objectives, you can enhance growth in GDP, you will by definition slow the rise in that particular outlay as a fraction of GDP. So that is a denominator-based view of what the policy decisions need to address.

In the numerator, the growth in Medicare is widely assumed to simply be the aging of the population, and indeed that contributes about 30 percent of the rise in Medicare as a fraction of GDP. The residual 70 percent, however, stems from the fact that health care costs have grown historically at a pace faster than GDP has grown. Indeed these projections make the assumption as do the Social Security and Medicare trustees that those costs will ultimately grow 1 percentage point faster than GDP. That is slower than history. History is that they have grown about two and a half percentage points faster than GDP. So attempts to move that rapid growth in health care costs toward 1 percent will simply achieve this curve, moving it further below will bend that curve down.

Chairman NUSSLE. Is there a magic number at which these expenditures begin to be a profound drag on the economy? Is it 15 percent of GDP, is it 20 percent? Is there a school of thought on when this becomes unsustainable for economic growth on the macro level before we talk about what the annual growth rate would be?

Mr. HOLTZ-EAKIN. Economics is inherently averse to knife edge solutions where one approaches to exactly a magic point and then falls over. Instead, as I said in my remarks earlier, any of these outlays will have to be financed somehow. If you assume they are financed by taxes, it is well known that the second component of the financing costs, the excess burden, rises more rapidly than does the tax rate. And so one will simply make the indirect cost of financing more and more expensive as the amount of taxes levied has to rise.

Where some of the direct and indirect costs balance the benefits of such programs is ultimately a policy call but there isn't a magic number. There is simply an increasing opportunity cost of these funds in the Federal government budget.

Chairman NUSSLE. But on an annual basis, eventually if you are growing faster than GDP, you are going to wind up in trouble?

Mr. HOLTZ-EAKIN. Oh, there is no question that if we continue to grow 1 percentage point faster than GDP forever, stopped in 2075, it simply is numerically impossible to continue that. Stein's law dictates that if something is growing faster that GDP, it just can't last forever. That is the position where one finds oneself when looking at Medicare and other health related programs.

Chairman NUSSLE. On the pension benefit, on the PBGC, you mentioned that in your testimony, is there a way we can begin by whether it is phasing into our budgetary practices a way to show that within our budget in a more responsible way? It may not be something we do next year but picking a time in the future, is it accrual accounting, how do we better demonstrate this in our budget so that we can be better at planning as well as recognizing the long-term obligations that some of these programs stand for in government?

Mr. HOLTZ-EAKIN. In general with insurance programs, I think the key is to try to put in the budget the expected present value of the commitment and that would include not just the inflow of premia, but the probability that there will be a pension line taken over by the PBGC. The obligation of Federal funds is the guarantee for that pension plan; it can easily follow the model of credit reform in terms of the principles of bringing that into the budget.

In practice, the kinds of things that go into that calculation—probabilities of pension plan default, differences across industry—are all complicated and hard to imagine the details at the start. So if Congress was interested in recognizing the existence of these liabilities, one possibility, and there are many others, would be to begin by simply showing some sort of flag in the spirit of the UMRA regulation where if something exceeded a certain threshold it was noted in the cost estimate or it was noted in the budgetary process so that Congress was aware of the implications in the insurance program. As people became more proficient and familiar with digesting the numbers, the actual estimates of the budgetary costs, it could be moved in in a more formal and numerical fashion.

There are many ways to get from where we are now, a lack of recognition, to a place where it was fully recognized in a dollar fashion.

Chairman NUSSLE. Thank you.

Mr. Spratt.

Mr. SPRATT. Thank you very much for your testimony.

In dollar terms, what is the actuarial shortfall in Social Security over the next 75 years?

Mr. HOLTZ-EAKIN. I don't know off the top of my head.

Mr. SPRATT. Does $3.3 trillion, something in that range ring a bell?

Mr. HOLTZ-EAKIN. One hears numbers of that scale, yes.

Mr. SPRATT. We have here the Social Security actuarial deficit as a percent of GDP is .7 of 1 percent and the present value in dollars is $3.8 trillion over the next 75 years. Do your records agree with this?

Mr. HOLTZ-EAKIN. We can certainly check them. The precise numbers, I don't know for sure.

Mr. SPRATT. Would you take this back and give us an answer for the record as to whether or not the way we have calculated the actuarial deficit of Social Security is correct?

Mr. HOLTZ-EAKIN. Certainly.

Mr. SPRATT. Looking at your chart, your layer chart with Medicaid, Medicare, and Social Security, I don't know who has control over that but in any event, Social Security, according to your table and your testimony, does go up by a significant amount. It goes up from 4.2 percent of GDP today, probably a bit more in 2003, to a peak of 6.2 percent, 2 percentage points of GDP. That is not inconsiderable given the growing size of our GDP pie, $11 trillion today, more in the future, but we have moved around portions of our budget, wedges in the budget pie of that magnitude before. Defense grew by that much in the 1980s, for example.

Would you agree that 2 percent of GDP is something that should be sustainable and manageable?

Mr. HOLTZ-EAKIN. As an outlay?

Mr. SPRATT. By itself, as an outlay, yes, over the next 70 years?

Mr. HOLTZ-EAKIN. Starting at what point and with what else held constant? I want to make sure I understand the question.

Mr. SPRATT. While it is substantial in dollar terms, looking at other budget reallocations over time, we have been able to do that, have we not, without really dislocating anything of great significance?

Mr. HOLTZ-EAKIN. Whether you have dislocated things of great significance is a policy call. Reallocation could take place. I guess my take on this chart would be that this is a sharp increase in overall demand for resources in the government sector, and if reallocations were to bring them into control, then that would make the problem more easily solved. But the resources are being added up in this presentation.

Mr. SPRATT. I look at that and I say Social Security by itself would be a problem but it is a manageable problem. When you add it to Medicare and to Medicaid, then it becomes a real difficult burden for the budget to bear and a burden for the economy to sustain. Would you agree with that?

Mr. HOLTZ-EAKIN. I think the nature of the problem is different. In Social Security, one sees two sources of growth in the outlays. The first is aging, shared with Medicare and Medicaid. The second in Social Security's case is that the benefits are indexed to real wages, and as real wages go up, the purchasing power of benefits goes up. Those are mechanically two sources of the rise in outlays. To the extent that one was comfortable with the overall level, then one could just stay with that.

With Medicare and Medicaid, you have the aging plus this growth in health care costs which thus far has proven to be quite intractable and where policy instruments are much harder to deploy.

Mr. SPRATT. Looking at Medicare, you have not factored in there the prescription drug benefit?

Mr. HOLTZ-EAKIN. No, I have not.

Mr. SPRATT. Because it is not a done deal. Basically, the beneficiary populations are the same between Social Security and Medicare. They are a little different at the margin but they are not greatly different. So the real increase in Medicare which is rising sharply as a percentage of GDP from about 2.2 percent in 2000 to about 6.0, almost 4 percentage points of GDP. Basically that difference is not due to beneficiary population growth because those are constants but it is due to the increasing cost of health care?

Mr. HOLTZ-EAKIN. As I said, 30 percent is aging, shared by Social Security; 70 percent is rising health care costs. And for Social Security about 55 percent or so is aging, and 45 percent is the rising value of real benefits. So they share that common aging component, but they differ in the other dimensions.

Mr. SPRATT. So we say it is a demographic problem but it is also a cost control problem and the larger part of the Medicare problem is a cost control problem, correct, 70 percent of it?

Mr. HOLTZ-EAKIN. Yes.

Mr. SPRATT. That is a major difference between it and Social Security.

Mr. HOLTZ-EAKIN. Yes.

Mr. SPRATT. You have had something intriguing in your comments about the Medicare prescription drug benefit, estimated the cost at roughly $400 billion between 2004–13 but under reasonable assumptions, you said by future drug spending and demographics, cost would exceed $1 trillion and could approach $2 trillion during the following decade. What would those assumptions be?

Mr. HOLTZ-EAKIN. The nature of that calculation is that if one goes to 2013 and takes a ballpark estimate of $75 billion as the direct spending for prescription drugs, common to the different bills that came out, H.R. 1 and S. 1, and has that grow at a 10 percent rate over the next 10 years, one is at about $1.3 trillion. That is a rate of growth in prescription drug spending that has been absolutely a common experience in recent years. That is without layering in any demographics, having more beneficiaries without altering any assumptions about utilization. So that is the nature of the calculation.

Mr. SPRATT. In the first 10 year time frame, if we assume drug prices will continue to grow at their previous rate of growth, then the cost of the package could easily be $1 trillion or more?

Mr. HOLTZ-EAKIN. The spirit of the calculation is illustrative, it is not a precise calculation but it is to make the point that in these entitlement programs, there are some things that get baked in the cake; and given the structure of the programs, they will continue in a way that the 10 year budget window does not capture. These drafts are meant to illustrate that. That calculation is also meant to illustrate it. It is just the next 10 years in addition to what is already baked in the cake, there is additional layer of icing being added.

Mr. SPRATT. So the key to making prescription drug coverage affordable is also controlling cost?

Mr. HOLTZ-EAKIN. It may be the case that the Congress decides to spend this money. This is just the cost side. Whether it is affordable or not is a value question. That depends on the value you place on the program. As I said at the outset, the testimony is focused on cost. It is a policy decision as to whether the benefits are large enough to merit that.

Mr. SPRATT. I haven't seen your estimate of the two House and Senate proposals now in conference. Did you elaborate upon these possibilities in your cost estimate of those two options?

Mr. HOLTZ-EAKIN. No. The cost estimates were designed to elucidate the first 10 years, as is standard practice in cost estimates and to explain not just what the numbers were but the basis for those estimates: the kinds of impacts we had perceived in terms of formation of delivery of the pharmaceutical benefit through private sector entities and the impact on the delivery of the AB benefit through PPOs, HMOs, things like that. That was the scope of that analysis.

Mr. SPRATT. You addressed the problem of capturing these likely costs in the budget which we are not doing today, not even on a present value basis, not for Social Security and not for Medicaid or Medicare. Medicaid, there are so many variables in there, it might be harder to predict than Medicare.

How do we do it? How would you propose we do it, as a supplement to the budget that is done on a regular basis or by integrating this information into the budget itself?

Mr. HOLTZ-EAKIN. In the end, I think that would become Congress' decision, what it wanted.

Mr. SPRATT. We want your advice. You are going to be serving on the FASB and one of the things you will find on the FASB is that we do things in the Federal budget that we are not going to let private corporations get away with. If a private corporation had a pension fund that was underfunded by as much as ours and Medicare benefits too, then it would have to make adjustments. All we have to do is declare it and profess our intention to deal with it in the prospective future and walk on.

Mr. HOLTZ-EAKIN. The spirit of my remarks would be in fact to include more in the budget in some cases and more in supplementary information in others. For example, I think we could move toward a better recognition of the budgetary cost of insurance programs, given the experience with credit reform. We could improve our estimates in credit reform. There are some things that with time and effort could be brought into the budget in the same fashion that credit reform estimates are now.

In other cases, for example, with these entitlements, I would argue they should be kept as supplementary materials. As I said, the dividing line between contractual/firm commitments and those which Congress retains the right to modify is far from a distinct one. Ultimately it will be a congressional decision but to the extent that option has been retained, I don't think it is appropriate to put the present value in the budget.

I am also not uniformly a fan of the present value calculations as supplementary pieces of information. Present values are designed to ignore timing. That is literally the point of them. In some cases, I think simply knowing the level of outlays that will ultimately have to be financed is the key piece of information along with the timing of the increase. As you pointed out, the more rapid increase in Medicare as opposed to Social Security is information that gets lost in the present values. So to the extent that the timing of the rise in Federal spending is important, present value misses that.

Mr. SPRATT. Let me ask you a couple of things and I will let other members move on with it.

Are you working at CBO on some sort of formulation so that we would get a warning as to the looming liabilities of Social Security, Medicare and Medicaid before we undertook big spending increases, big benefit increases or big tax cuts?

Mr. HOLTZ-EAKIN. I know my predecessor, Dan Crippen, started a long-term modeling group designed to be better able to understand the long-term implications of legislation in these entitlement areas. We continued that work. It is far from complete or perfect in any way, but we are trying to build the capacity to be able to evaluate these kind of programs over longer horizons where it is actually relevant and important to Congress. How such information was deployed and the manner in which it was delivered are something we would need to work with you on.

Mr. SPRATT. Let me ask you about discretionary spending. Since you are going on the Financial Accounting Standards Board, if you had a corporation that knew it was going to sustain somewhere between $3 [billion]–$5 billion a month for an activity in which it was engaged for the forthcoming fiscal year, do you think it should be reflected in its projection as a contingent liability for the future?

Mr. HOLTZ-EAKIN. Yes.

Mr. SPRATT. We have that situation now with discretionary spending with the cost of deployment to the Persian Gulf. We have treated this as a mandatory thing but the chairman will tell you because he has been an advocate for trying to book every year some sort of actuarial equivalent to the amount we spend on emergencies, hurricanes and tornadoes, fires and droughts, and things like that, we know over a period of time what it is likely to be but we have not been able to sell the idea that some amount should be put in the budget as a realistic reflection of a likely cost.

We have an even bigger example in the discretionary accounts this year in that we know there is a supplemental coming for the Persian Gulf and we know it is probably going to be over $25 billion, maybe as much as $50 billion, but it is not reflected even in the mid-session review. Do you think that is a problem?

Mr. HOLTZ-EAKIN. I think that to the extent there are expenditures that Congress can quantify, they ought to enter the budgetary calculations. It is literally above my pay grade to make decisions about whether we made a commitment on that but if we know we are going to spend money and we are going to spend it this year especially, certainly it ought to be reflected in budgetary decisions.

Mr. SPRATT. Thank you, sir.

Chairman NUSSLE. Mr. Diaz-Balart. Mr. Cooper.

Mr. COOPER. This is a very important hearing and I wish we had more members present. Of course it is a busy time and members were up late loading. I think another factor is the future has no lobbyists. As we focus on these vitally important long-term issues, there is a natural tendency of today's politicians to shortchange them.

I also think it is very difficult for folks to grapple with the magnitude of the numbers we are talking about. I have come to admire Peter Fisher's statement, the Treasury Under Secretary, who said basically government is an insurance company that is at least $23 trillion in the hole with side businesses in defense and homeland security. That does more to encapsulate in one sentence the nature of government because so many folks back home don't even view Medicare and Social Security as government programs. That is their money and they would deny the government has much to do with that. We face a real problem both in analysis and of communication.

I appreciated your statement. Yesterday we had a hearing on whether the Air Force should buy or lease aircraft tanker fleets, about $17 billion. I thought I understood you to say that it is the same outlay of government money, it should be scored virtually the same whether we buy or lease. the government is taking control of that property regardless of the legal formalities, correct?

Mr. HOLTZ-EAKIN. Yes and I commend to you a fine study on lease/purchase arrangements that CBO put out earlier this year.

Mr. COOPER. On the aircraft decision?

Mr. HOLTZ-EAKIN. Not on the aircraft decision but on this kind of financial arrangement.

Mr. COOPER. There are so many other issues to get into. A statement the chairman made in our last hearing worries me and I hope I am quoting him correctly. This was in USA Today. It says, "Tax cuts do not cause deficits. You only borrow money in Washington for spending." Perhaps I got the chairman's statement wrong and if the chairman would like to amend or correct that, I would be delighted to give the chairman the benefit of the doubt. That is a statement that is hard for me to understand and I only have two degrees in economics. Can you understand or make sense of that?

Mr. HOLTZ-EAKIN. I think one can appeal to an accounting identity and one can appeal to a politician and one can appeal to economics. The accounting identity is this: If you hold spending fixed and cut taxes, the difference will be borrowed. That is the easiest way to make sense of the math.

Mr. COOPER. But deficits are like a see-saw, aren't they, taxes on one side and spending on the other and to get balance, you have to focus on both sides of the see-saw, not just one side or the other?

Mr. HOLTZ-EAKIN. The spirit of my remarks was that over the long-term, you will have to finance your spending decisions in some way, so focusing on what you have committed in the way of spending is the appropriate first step. Figuring out how to finance it is certainly an important issue over the near term. If you are going out 1, 2, or 3 years, you want to look at both sides of that equation. I was focusing on the spending as I said because the nature of the hearing was really long-term issues.

Mr. COOPER. Sometimes democracies inflate away the value of the currency too. They try to avoid financing deficits until it is almost too late and the value of the currency deteriorates.

Mr. HOLTZ-EAKIN. Despite Chairman Greenspan's ability to opine on fiscal policy, I am going to resist the temptation to opine on monetary policy. It would probably go on too long.

Mr. COOPER. But that is also a possibility isn't it? Not everything in life is financed. Sometimes there are worse outcomes.

Mr. HOLTZ-EAKIN. There are different forms of financing. It is financed one way or another. Inflation taxes are taxes nonetheless.

Mr. COOPER. You mentioned that the Medicare drug bill is not factored into your chart, the future of Medicare spending. Can you give us an idea of how the curves would change? The figure of $1 trillion was mentioned. I assume that would be a dramatic increase in the bandwidth of Medicare section on your chart?

Mr. HOLTZ-EAKIN. Yes. We haven't done the full 75 years. I wanted to put this in the testimony largely to point out the shortcoming in these 10 year budget windows and how longer term information is important. To the extent that a final bill is passed and details are available to actually do a long-term projection, that would be possible for us to undertake.

Mr. COOPER. One of Peter Fisher's recommendations is that we have an accrual spending statement on every measure passed by Congress. We do not do that today. Do you think that would be a helpful policy improvement?

Mr. HOLTZ-EAKIN. It is one of the potential pieces of supplemental information that I think would be helpful. More supplementary information about long-lived programs I think is something Congress would benefit from. You are in a better position to decide than I. Whether it is an accrual statement, which as I said loses timing, or whether it is simply some information about the scale of the obligation and the rate at which it arrives depends on who is using the information and for what purpose.

Mr. COOPER. Today's system of arbitrary sunsets and deadlines and we don't count things that are more than 10 years out, things like that, this current system is so arbitrary as to almost be meaningless because the last tax cut bill was either scored at $350 billion or at $1 trillion plus depending on whether you gave out year effects to the measure.

I see my time has expired.

Chairman NUSSLE. Since you have two degrees in economics, I was giving you the benefit of the doubt.

Mr. Diaz-Balart.

Mr. DIAZ-BALART. I apologize for the noise problem before.

Along the same line as Mr. Cooper's questions, given the importance of long-term Federal obligations and the effects on the economy, which are pretty obvious, would it not be appropriate to have the CBO submit not only the projected spending revenue effects of legislation we passed but also of the effect on the GDP which is a huge issue?

Mr. HOLTZ-EAKIN. Under current CBO procedures, under a 10-year projection, for example, we do in fact include the impact on GDP. We develop a forecast for the economy which includes the current state of policy at any point in time and its implications for the future. We then layer on top of it the current law on both the outlay and tax side to get a projection of the future course of the Federal budget.

Mr. DIAZ-BALART. What would you suggest would be our next step in improving budget for long-term commitments?

Mr. HOLTZ-EAKIN. Quantitatively, the entitlements—shown in the picture to my left—produce the large known number. Information of some sort that informed Congress about decisions that altered that picture in one direction or another I think would be a very valuable step in the right direction.

The vast array of other suggestions I had were designed to place commitments for which the scale is really unknown in the budget at least or supplementary information about them in the budget information so that they could be better understood and compared with existing programs.

Mr. DIAZ-BALART. As things get more and more complex, which tends to happen, is our budgeting process prepared to handle the increased complexity of budgeting for long-term commitments?

Mr. HOLTZ-EAKIN. It is a fair concern, I think. As someone who consumes these budgets, you are sure you appreciate the complexity. As I work with the CBO staff which I have nothing but praise for, I become painfully aware of the difficulty and the complexity in the many programs. I think there is a clear and important path toward using more and more kinds of budgetary information across a broader array of programs.

The first step is, in fact, to not just launch into it but to make some point of recognition—supplementary information if you want to bring a formal point of order or some such device—into the budget price. That would be the next step. Only after both the Congress and anyone who is providing this information have become comfortable with the procedures, after they have shown some stability and robustness in a variety of settings, do you want to incorporate them into the budget process in any real formal sense by which you might do allocations on the basis of them or something like that.

Mr. DIAZ-BALART. Thank you, Mr. Chairman.

Chairman NUSSLE. Mr. Scott.

Mr. SCOTT. Thank you, Mr. Chairman.

Mr. Holtz-Eakin, sometimes it is nice to start off with the facts, then you can get to the excuses, the explanations, the allegations, the spin. This is the chart from February of the deficit year by year and shows the deficit under Johnson, Nixon, Ford and Carter, the deficit under Reagan and Bush. Let me ask you whether or not you agree that at the end of the Clinton administration not only had the deficit been eliminated but even taking into consideration Social Security, Medicare and keeping those in the so-called lockbox, there was an actual surplus. Is that accurate?

Mr. HOLTZ-EAKIN. I want to make sure I understood the chart. It is not the unified surpluses or deficits; it is in fact the budget.

Mr. SCOTT. Right.

Mr. HOLTZ-EAKIN. There was a small on-budget surplus at that time.

Mr. SCOTT. In February, the deficit estimate was about $500 billion for next year. Is that right and since then it has gone up $150 billion since February, right?

Mr. HOLTZ-EAKIN. These are the OMB estimates of the on-budget surplus?

Mr. SCOTT. Right.

Mr. HOLTZ-EAKIN. I don't know the on-budget surplus off the top of my head.

Mr. SCOTT. The question we would have to ask is looking at these numbers how bad it would have to get before we concluded that somebody doesn't know what they are doing. Let me show you the next tax cut. Does this tax cut chart accurately reflect the 20 percentile distribution of who got the tax cuts?

Mr. HOLTZ-EAKIN. I'd have to study this chart more carefully.

Mr. SCOTT. After we passed the tax cuts, does this chart accurately reflect the jobs that have been created by administrations going back to Truman?

Mr. HOLTZ-EAKIN. That looks about right.

Mr. SCOTT. Actually it is a little out of date again. It is not $2.5 million, it is not $3 million but the direction is pretty solid. That chart includes the Korean War, the Vietnam War, the hostages in Iran, the cold war, Somalia, Grenada as well as 9/11. The next chart is the interest on the national debt. The green bars show where the interest on the national debt was going. The red bars show the interest on the national debt after we got these tax cuts passed. The blue bar is the defense budget. Does the administration's budget in 2013 show the defense budget and the interest on the national debt as essentially the same?

Mr. HOLTZ-EAKIN. We don't have 10 year projections from the administration at this point.

Mr. SCOTT. Did the CBO numbers for the 2013 budget show interest on the national debt and the defense budget essentially the same?

Mr. HOLTZ-EAKIN. I will have to check.

Mr. SCOTT. The next chart is the Social Security challenge that shows the cash flow in Social Security chart that 2017 may have adjusted a year or so one way or the other but essentially shows the challenge we have in Social Security, in paying Social Security for the future?

Mr. HOLTZ-EAKIN. It is probably an accurate accounting of Social Security. An economist would suggest that is not really the challenge, that a unified deficit is a better measure of the economic resources one will require in the Federal budget. The trust fund represents a device within the Federal budget to keep account of Social Security but it is not an economic concept that has consequence.

Mr. SCOTT. We are going to have to somewhere in the unified budget find the cash to pay the red. Did you agree with Mr. Spratt's comment that the present value of the Social Security problem is about one-third of the present value of the tax cuts?

Mr. HOLTZ-EAKIN. It is not a calculation I have done. Present values are useful when there is a firm commitment on the incoming side and the outgoing side. The degree to which there is malleability on both sides, both on the receipts and on the outlays, makes it less informative.

Mr. SCOTT. Let me ask a direct question. Looking at the cash flow of the Social Security trust fund and the interest on the national debt going through the ceiling, how can you creditably say there is any intent to pay Social Security in the future?

Mr. HOLTZ-EAKIN. I would direct you back to this chart which I think is illustrative. it shows the commitment to spend under current programs and current law and then the question becomes how such commitments will be financed if they are to be met.

Mr. SCOTT. I noticed your chart doesn't include interest on the national debt which we are showing as virtually equivalent to the defense budget.

Mr. HOLTZ-EAKIN. To show the interest on the debt, you would have to make a specific assumption about the timing of the financing and the amounts borrowed in different years. Since the point of this is to highlight that in the long-term, you have a commitment to pay for one way or another. It was clear to leave out the second decision, which is the timing of the financing on the tax side.

Mr. SCOTT. Mr. Chairman, I would point out that the CBO budget shows interest on the national debt at about $500 billion for 2013. As mentioned, somebody has to pay it so I appreciate it. My time has expired.

Chairman NUSSLE. Thank the gentleman.

Ms. Majette.

Ms. MAJETTE. Thank you, Mr. Chairman. Thank you, Mr. Director, for being here this morning.

If you will indulge me, I am going to take us off the beaten path for a couple of minutes. I wondering the degree to which the CBO takes into account the reductions in cost in one program due to spending in another. Let me give you an example.

We are currently in the process of reauthoriztaion of the Head Start Program. Studies have shown that students who complete the Head Start Program are five times less likely to go to jail or to prison than students who do not complete the Head Start Program and are not otherwise put at the starting line in terms of their education at the same place.

When you look at the overall cost of Head Start, which is $6,500 per year per child, and currently we are only covering 900,000 children, only one in five children at that figure, to what degree can you take into account reductions in the cost of incarceration and the effects that has on our country with respect to the cost of covering more students in the Head Start Program?

For your information, I am a former State court judge and I know that in my county, in DeKalb County, it costs $52 a day at a minimum to feed and house an inmate each day. So you are looking at essentially $18 a day per child for Head Start versus a minimum of $52 a day in a jail.

What would you say with respect to balancing that and how we might be able to use those kinds of analyses in dealing with this deficit problem?

Mr. HOLTZ-EAKIN. I certainly won't pretend to be an expert on incarceration. It is not something I want to learn about personally in any way. But as a matter of the way CBO does its business, for example, on a cost estimate, it does attempt to think comprehensively about the impacts of any proposal. For example, it is a straightforward part of doing our business in the Medicare area to look at ancillary impacts on Medicaid in order to get the overall impact of a proposal on the spending in the Federal budget.

The initial question is does CBO think about these interactions? The answer is, yes, we do our very best to think about the way in which the proposal will affect the array of individuals and actors in the private sector and as well, their impact on the Federal budget.

With respect to specific estimates on Head Start, I am not conversant with all the degrees to which we have brought in different kinds of behaviors. An important issue to point out is that in a 10-year budget window, it strikes me as unlikely that you would capture those kinds of feedbacks.

Ms. MAJETTE. In terms of that general kind of comparison, you are saying the CBO does take that into account?

Mr. HOLTZ-EAKIN. As a matter of routine business in all areas of our cost estimates.

Ms. MAJETTE. So if you are talking about medical coverage, it would make more sense to spend more money at the outset in terms of prevention and screenings than to wait until a later point in time when you have to spend more money for those higher costs that are ancillary to the failure to address it earlier on?

Mr. HOLTZ-EAKIN. Certainly, in thinking about issues in the health area, we have spent a tremendous amount of time and effort to look at the peer review literature and find out the degree to which for example, a disease management program can be shown to bring long run reductions in the overall cost of care for an individual. That kind of analysis is one of the reasons that CBO really devotes effort in its areas of study outside of just straight cost estimates. We do studies at CBO so that we are better informed about the nature of the impacts when it comes time to look at a budgetary issue narrowly defined. Certainly we have looked at those kinds of feedbacks as many in health as we can find.

Ms. MAJETTE. Thank you. I yield back the balance of my time.

Chairman NUSSLE. Mr. Kind.

Mr. KIND. Thank you, Mr. Chairman, and thank you, Mr. Holtz-Eakin, for your presence and testimony here today.

As my friend from Tennessee, Mr. Cooper, indicated, this is an incredibly important hearing. It is one that forces us to look out into the future rather than just focusing on the next election which I think is incredibly important for us policymakers to do more of rather than less of as we make these decisions that are going to affect not only tomorrow but the next generation and the next after that.

If anyone deserves a new chapter in the book of John F. Kennedy's "Profiles in Courage," it is you because you are stepping into what seems to be the perfect fiscal storm of some huge challenges that we are going to be facing together as a Nation.

Unprecedented budget deficits are exploding on the scene again. What is perhaps most disconcerting about it is there doesn't appear to be any plan on how we can reverse course to instill some budget discipline, bring things back into balance, because it is all happening at exactly the worse moment in our Nation's history, on the eve of close to 80 million of our so-called baby boomers and their massive retirement, the demographic time bomb that many of us are aware of which is the 800 pound gorilla in our deliberations every time we take up these policy issues.

Unlike the deficits we faced during the 1980s and early 1990s, we don't have the luxury of a decade like the 1990s again, the time to reverse course, bring things into balance, start reducing the publicly held national debt and preparing our country for what we know is going to start occurring in a few short years. That is very disappointing because as long as the policies are pursued and we see the red ink mounting, it is going to be awfully hard for future Congresses, and especially the next generation and the children of today to be able to take up these challenges themselves and to reverse course.

As the father of two little boys myself, I am very concerned in the direction of fiscal policy and the long-term economic consequences that might bring.

Looking at the 1990s, I think there were certain things the Congress along with the administration did well in order to instill some budgetary discipline, certain tools that were available to policymakers, certain restrictions on what you could and couldn't do, not the least of which was the PAYGO rule which expired unfortunately in 2000. The new administration and Congress had an opportunity of extending the PAYGO rule but passed on it. I think it was one of the most important mistakes made starting a new decade facing what we do today.

I am wondering whether you have had an opportunity and you probably have given the scholar that you are, to study the history of certain budget disciplines, especially the PAYGO rule and if you have any opinions in regards to whether a certain type of fiscal tool is something that makes sense and something the Congress and the administration should seriously consider in order to start developing a plan on how we get out of the sea of red ink which is accumulating by the minute today.

Mr. HOLTZ-EAKIN. Opinions are a dangerous thing for CBO directors, but let me review briefly some things we have seen in the United States. In the early 1980s, we had deficits as a fraction of GDP of about 6 percent. I think it is fair to say there was a realization that structural deficits of that magnitude could not be sustained, and efforts were undertaken to address that.

The first form of those efforts were Gramm-Rudman-Hollings deficit targets, which did not work and which were missed not once but twice, two different iterations. Then the discipline mechanisms changed to controlling spending in the form of discretionary caps and in terms of the PAYGO rules that you mentioned. Congress and the administration moved forward in that fashion.

Then in the late 1990s, there was a great deal of attention paid to the scale of the on and off-budget surpluses, and that served implicitly as some sort of targeting device for fiscal policy in the United States.

I would argue that in the absence of some sort of targeting device about which there is some consensus, mere rules will not be sufficient to achieve any such objective. You first have to identify an objective as a Congress in whatever fashion is best and then put in place rules that can support movements toward that fiscal policy target.

Mr. KIND. One of the concerns I have is that the future of the country and economic growth, getting ourselves out of this budget mess is pretty much being bet on these large tax cuts stimulating economic activity and growing the revenue stream in the out years. It is a huge gamble that is occurring because if it doesn't occur, if we don't see the huge revenue increase that my friends on the other side claim will come from these big tax cuts and the extenders which we know are coming tomorrow, the next generation is going to be left holding the bag. That is going to be very difficult for them to wrestle with.

The dynamic that occurred in the 1990s was really twofold. One is there was restraint on spending and we had a decline all 8 years in the Clinton administration on spending as a percentage of GDP. That now is reversed and we are back up again.

The other dynamic was that the urge for large, massive tax cuts in the 1990s was also blocked, so there was a spending part of it and there was a revenue part of the equation which enabled balance to occur and some short term surpluses to happen at the same time. It is something that doesn't exist today, that same type of balance on long-term fiscal outlook.

Again, I thank you for your testimony today.

Mr. HOLTZ-EAKIN. Certainly.

Chairman NUSSLE. Mr. Shays.

Mr. SHAYS. Thank you for being here.

I have had the pleasure of being on this committee for 10 years. This is my 11th year and I had a bit of interruption but when I look at what we have done in spending over the last years, I would like to have you pull up chart 21, then we will go to 22, 23, 24, 25 and 26.

Chart 21, we see Medicaid going up quite significantly under Republicans and Democrats. Medicare, chart 22, we see tremendous increases. Under Veterans Affairs, 23, we are seeing tremendous increases. Under Transportation, 24, you see spending going up. This is not spending that my colleagues on the other side of the aisle have voted against. They have thought we have not spent enough. Chart 25, Labor, HHS, educational appropriation. As much as we have increased spending in the last 5 years by 65 percent, it is still not enough for our colleagues on the other side of the aisle.

Then go back to chart 8. I want you to look at chart 8 and tell me how you react to it. It is spending growth out of control, per capital real spending, excluding net interest. It is approaching almost $6,500 per capita and I want to know if these are the same numbers you are seeing as well?

Mr. HOLTZ-EAKIN. This is the total including entitlements, discretionary? We can check and make sure the numbers match.

Mr. SHAYS. When you look at this chart, does this chart surprise you? Do you see it? Are you looking at it?

Mr. SHAYS. We follow the numbers on a regular basis, as you know, and try to inform Congress about these matters.

Mr. SHAYS. I look at trend lines and I am thinking the last 2 years, that has almost gone up straight practically in comparison to what it did before.

The irony to this in some ways is that in spite of the fact my colleagues on the other side of the aisle don't like the tax cut, they are not supporting repealing it. They had an opportunity to sign on to repeal it. That is the mess we are in.

The only reason I mentioned the first part is to say that having seen the arguments, I don't know if it is a Democrat or Republican problem, I think it is a problem of Congress and even when I look at the chart showing the Presidents who were in power, Ronald Reagan most of the time had a Democratic Congress, so I just kind of think we are all part of this mess.

Having said that, I want you to tell me when we look at spending because spending is where the problem is, is it the entitlements that concern you more or the discretionary spending?

Mr. HOLTZ-EAKIN. For the purpose of this hearing, which is about the long-term impacts, I think the entitlements are in fact the large knowable piece of the budget that one can take a look at and see the implications for the long-term.

Our assumption in putting together estimates of the other spending is that discretionary spending ultimately rises as a constant fraction of GDP. It is very difficult for us to forecast and we did not attempt to predict the kinds of discretionary appropriations that Congress would make.

Mr. SHAYS. So if entitlements are the key problem, would you be advocating to Congress that we do what we had done when we brought our bill out of committee before it was chopped apart by many on the other side of aisle when we tried to freeze discretionary spending for 1 year or at least hold it to a 1 percent increase? Do you think that was an advisable thing to do?

Mr. HOLTZ-EAKIN. My message to you is, that is a policy decision that the Congress will have to make. My point is simply that over the long-term, these spending commitments will have to be financed in one form or another. A rise to 28 percent of GDP if financed by taxes in any given year would be a rate of taxation that is well above historical norms.

Mr. SHAYS. I am not quite sure I understand your position that slowing the growth of entitlements or freezing them is not something you can comment to. Why can't you comment on that?

Mr. HOLTZ-EAKIN. Whether it is desirable or not, my testimony focuses on the cost not the benefits. It would lower the cost, no question. Whether it is desirable is an issue of the benefit of those outlays compared with the benefits of other Federal programs, and of the use of those funds in the private sector, and that is a policy decision.

Mr. SHAYS. My time is up. I just would have to say to you I understand it is a policy decision but you don't seem to want to speak to the consequences of a policy decision.

Mr. HOLTZ-EAKIN. It would lower the overall claims on the private sector. That is the spirit of the message I am trying to convey today, which is in the end, there are finite resources.

Mr. SHAYS. Why would there be a description of you as a profile in courage if you are basically not expressing opinions about these issues and providing warning signs and so on? Where does that profile in courage description apply to you?

Mr. HOLTZ-EAKIN. I am not the person who gave myself that label, but I would suggest that if one wanted a warning sign about the issues that Congress would face going forward, this particular set of current service spending demands is in fact a very pertinent piece of information that Congress ought to think about to decide how it will finance or choose not to finance them by reducing spending. That part is the call.

Mr. SHAYS. What I am trying to get a handle on is that you had an opportunity to discuss with this committee whether or not you have greater concerns about entitlements or discretionary spending and you said that since this is a hearing about long-term expenditures, then you refer to your chart. Can't you be a bit more emphatic about what would concern you as an American and as someone who focuses on the budget? Should our concern be more on entitlements or should it be more on discretionary spending?

Mr. HOLTZ-EAKIN. There are a variety of answers, none of which will, I suspect, satisfy you.

Mr. SHAYS. Your job is not to satisfy me but to educate me and to not be milk toast. I want to know some facts. What is the big concern?

Mr. HOLTZ-EAKIN. Fact: If you take a dollar from the private sector and devote it to entitlement or discretionary spending programs, you will either crowd out some private sector consumption or some private sector investment and the economic consequences will be identical.

Mr. SHAYS. Which is more likely to occur based on your study of Congress? Entitlements will crowd out or discretionary?

Mr. HOLTZ-EAKIN. It is not possible to distinguish between them. They will be financed either in some composite way by taxes or by borrowing. Both will crowd out.

Mr. SHAYS. Which is the biggest growth in the last 15 years?

Mr. HOLTZ-EAKIN. If you look at the Federal budget even longer than that, we have switched from a budget that had a dominant character that was discretionary spending to now a budget that is denominated by entitlement spending. There is a lot more of the total budget devoted to the entitlement programs than to discretionary programs.

Mr. SHAYS. If I had answered the question if I was sitting there, I would have said Congressman, the bottom line is the part of the budget that you guys don't vote on is the one that is growing the most and you had better get a handle on that part of the budget or we are in deep trouble. That to me may be not saying specifically but that is the kind of thing I would expect from my budget director.

Thank you, Mr. Chairman.

Chairman NUSSLE. Thank you.

Are there other members who have an additional question? The reason I ask is, I have been told we will have votes around noon and we will have our typical series of votes. I think six or seven is what I am hearing.

If there aren't any other questions for our budget director, I think it probably would be a good idea to move on to the second panel so that we can get that in before the votes.

If there aren't any other questions, I appreciate your testimony today. It is a good start. We are going to have more we have to discuss obviously. There is a lot of interest in this.

Thank you for your testimony. We will enjoy working with you on solving this.

The next panel consists of the distinguished William G. Gale from the Brookings Institute, Tax Policy Center. He has been before our committee before. We welcome you back to the committee. Your entire written statement as you have presented it will be made a part of the record.

During the time you have, you may summarize and give us the high points you feel we should know and then we can have a chance to ask you a few questions as well. Welcome back to the committee and we appreciate your attendance here today.

STATEMENT OF WILLIAM G. GALE, BROOKINGS INSTITUTION, TAX POLICY CENTER

Mr. GALE. Thank you for having me testify this morning. It is always an honor to appear before this committee.

It is also an honor to appear immediately following Doug Holtz-Eakin, my friend and former co-author who I think is doing a fabulous job at CBO.

I would like to make five main points in my testimony. Before I do that, let me just say that any emphasis on long-term budget issues is welcome and I especially appreciate the committee's attention to that matter.

The first main point is the conventional wisdom is accurate. The United States does face a long-term budget deficit in the coming decades and a big part of that is that Social Security, Medicare and Medicaid will expand as you have just heard in the previous session.

There is uncertainty about the precise level of the fiscal gap or the long-term shortfall but there is little uncertainty that it will actually be there. Almost every study suggests that under a huge variety of assumptions, we will see a long-term fiscal gap.

The second point is that one can overemphasize the role of Social Security, Medicare and Medicaid in the long-term fiscal gap. There is another big part of the problem and that is the potential tax cuts on the horizon that would occur if we remove the sunsets in the existing tax code. If all the sunsets were removed, revenue would fall by 2.4 percent of GDP as in 2013. If in addition to that, we actually fixed the alternative minimum tax so only 3 percent of taxpayers stayed on it, which is about the current level, revenues would fall by 2.7 percent of GDP.

One of the problems with getting the public to focus on the long-term budget issue is when we look at tax cuts or spending programs, we talk about 10 year numbers. So a Medicare prescription drug benefit is $400-some billion. The tax cut was $350 billion. When we talk about Social Security and Medicare financing problems, we talk about 75 year shortfalls. So numbers in Social Security and Medicare are very big but they look bigger relative to the tax cuts than they would if we reported the numbers on an equivalent basis.

For example, the 75-year shortfall in Social Security could be fixed with an immediate and permanent cut in spending and raise in taxes of $75 billion, .7 of 1 percent of GDP. That is about 40 percent of the tax cuts due to legislation in the last couple of years.

When we talk about Social Security being a big huge problem, it is important to realize if you think about it in the same accounting frame as you think about other taxes and spending programs, it is a manageable problem and Congress is making decisions every year that are at least as big if they are made permanent as fixing the Social Security shortfall would be.

For example, the 2.7 percent of GDP loss in tax revenue that comes from extending the sunsets or removing the sunsets and fixing the AMT is almost four times as large as the Social Security deficit if both of them were tracked in a similar metric. It is larger than the permanent debt in Social Security. And over the next 75 years, if the tax cuts are extended, they would cost more in revenues than it would take to fix the Medicare trust fund and the Social Security trust fund over the next 75 years.

So the main message here is that the decisions that you make on an everyday basis about current tax cuts, current spending bills, can have very large long-term implications if they are made permanent, and that, therefore, when we talk about Social Security and Medicare as the real fiscal danger, we should also add extending the tax cuts as a real fiscal danger, because it is the same order of magnitude.

Alright, the third point I want to make is there is no hidden pot of gold waiting for us in terms of tax deferred retirement accounts. There have been a bunch of recent media activity about research by Stanford University professor, Michael Boskin. The press reports and some aspects of Boskin's paper suggest that future revenues from tax deferred savings plans are left out of the long-term budget calculations and that they are large enough to eliminate most or all of the fiscal gap. These suggestions are inaccurate. In fact, the underlying fiscal gap calculation already includes almost all of the revenues that are in Boskin's number and, as a result, adjusting the estimates to take account of Boskin's projection generates almost no change in the budget outlook. Nor are we likely to see $12 trillion in net present revenues. The right number is probably closer to $1 trillion, and could well be negative.

There has been one useful aspect of the sound and fury about this report, though, and that is, when the report came out, a number of people said, well, this justifies further tax cuts now. And the logic of that is that the long-term fiscal situation should have an impact on current policy. Then when it came out that the $12 trillion really isn't there, then obviously it doesn't justify current tax cuts now. But the logic still holds; the long-term fiscal situation should have an influence on what we do or what you do now. And so I think that is an important lesson to take from that. But I think it is also obvious now, from looking at the data, that there is no hidden extra revenue out there waiting for us.

Point four, the economic effects of persistent budget deficits are gradual, but they are debilitating nonetheless. I believe the chairman asked in the first session is there sort of a flex point; is there a point at which deficits become overwhelming. The short answer is no. Deficits are not like earthquakes. An earthquake happens, a building falls down, anyone can walk by and say that earthquake caused that building to fall down. Deficits aren't like that; the effects of deficits are much more gradual, they are more insidious.

If you like animal analogies, you should think of deficits as termites in the woodwork, sort of gnawing away at the capital stock over the long-term; they aren't the wolf at the door threatening an immediate emergency. So think of long-term gradual declines in economic performance due to budget deficits.

And the reason that occurs is that the real problem created by budget deficits is that they reduce national saving, which in turn reduces the assets owned by Americans and therefore reduces future national income. These effects can be sizeable, especially in the long-term. Conventional estimates that I have developed based on a model that was originally written by the Chair of the Council of Economic Advisors, Gregory Mankiw, shows that just the decline in the fiscal status since January 2001 will reduce real GDP in 2012 by 1 percent and will reduce national income in that year by about $2300 per household. That is just due to the fiscal deterioration. Now, these effects will persist over time, that is, they will gradually get bigger and bigger, so they are long-term costs that the country will have to bear.

Much of the debate about the deficit focuses on interest rates. I think this is a little bit of a side show. The deficit affects national saving regardless of whether it affects interest rates. I do think there is evidence that deficits affect interest rates, though, and we can talk about that if you are interested. Nor does it matter if the deficit is financed by capital inflows from overseas. If capital comes in from other countries, that just means that the amount that we produce in this country doesn't change. But because we borrowed more from others, our claims on that production fall, and, therefore, our future national income still falls.

Alright, the last point, the fifth point I want to make is that the fiscal problems that the country faces are unlike any other that we have faced in the past. We will likely have to find a new way to deal with them. The notion that Federal spending can be held to a post-war norm of 19 percent of GDP I think seems virtually impossible to maintain without either severely cutting the major entitlement programs or completely eliminating the rest of the government.

Basically, the short answer is you can't get there with spending cuts alone, although cuts in wasteful, fraudulent, or abusive spending, of course, are always welcome. In future years, the charts that were up over here showed that spending on Social Security, Medicare, and Medicaid alone will exceed 19 percent of GDP, which has been the post-war average for all of government.

So I think it was the CBO director who said you do not face an easy task. I certainly agree with that. The one point to add, though, is that just because spending is bigger than taxes doesn't mean that spending is too high; it could mean that spending is providing the benefits that the American public wants and, therefore, we need to raise taxes. In any case, that is your decision. But the unpleasant implication of all of these findings that a long-term resolution of these issues will either have to destroy the role of the Federal government in American society or it will have to anticipate significant increases in tax revenues as a share of the economy.

Thank you very much.

[The prepared statement of Mr. Gale follows:]

PREPARED STATEMENT OF WILLIAM G. GALE, BROOKINGS INSTITUTION, TAX POLICY CENTER

Chairman Nussle, Mr. Spratt, and members of the committee, thank you for inviting me to testify today. It is always an honor to appear before this committee. My testimony focuses on five main points.

First, the conventional wisdom is accurate: The United States faces substantial projected fiscal deficits in the coming decades. A big part of the reason why is that increasing life spans, the retirement of the baby boom generation, and changes in health care technology will generate persistent increases in spending on Social Security, Medicare, and Medicaid that far outstrip the rate of growth of the economy.

Second, there is another big part of the problem: namely, the sunsets that are in the tax code. If all of those sunsets were removed, revenue would fall by 2.4 percent of GDP on a permanent basis. If, in addition, the alternative minimum tax is reduced so that only 3 percent of taxpayers stayed on it—about the current level—revenues would fall by about 2.7 percent of GDP.

These prospective revenue losses are huge. They are more than three times as large as the 75-year actuarial deficit in Social Security, expressed as a share of GDP. They exceed the 75-year actuarial deficit in the Social Security and Medicare Trust Funds. They are larger than the permanent deficit in Social Security.

These facts imply that the aggressive tax-cutting agenda that the administration has pursued the last few years deserves equal billing with Social Security and Medicare as "the real fiscal danger." They also imply that the decisions you make about extending the tax cuts, about removing the sunsets, have long-term fiscal implications that are greater than those that arise from fixing the entire Social Security problem.

Third, there is no hidden pot of gold waiting for us in future revenue from tax-deferred retirement accounts. Recent press reports have grossly overstated the impact of research undertaken by Stanford University professor, Michael Boskin. The press reports and some aspects of Boskin's paper suggest that future revenues from tax-deferred saving plans are (i) omitted in fiscal gap calculations, (ii) large enough to eliminate most or all of the fiscal gap, and (iii) likely to raise $12 trillion in revenues through 2040.

These suggestions are flawed. In fact, the underlying fiscal gap calculations already contain almost all of the projected revenues. As a result, adjusting the conventional estimates for the difference between Boskin's projections and the projections that are built in to the fiscal gap estimates has trivial effects on the estimated long-term fiscal gap and on estimated future budget deficits. Nor are we ever likely to see $12 trillion in net revenues from tax-deferred retirement accounts. After adjusting Boskin's estimates for reasonable parameter values, an error in the computer code, and proper treatment of interest payments, the revenue effect will be either close to zero or possibly negative.

Fourth, the economic effects of persistent budget deficits are gradual but they are debilitating nonetheless. The real problem created by budget deficits is that they reduce national saving, which in turn reduces the assets owned by Americans and hence reduces future national income. These effects can be sizable, especially in the long-term. Conventional estimates, based on models developed by the CEA Chair Gregory Mankiw, indicate that the decline in the fiscal outlook since January 2001 has reduced GDP by at least 1 percent in 2012 and national income per household by $2,300 in 2012. These effects will persist over time. To put it differently, controlling the deficit is a pro-growth policy.

Much of the public debate focuses on how deficits affect interest rates. The impact on interest rates can be an important channel through which deficits matter. But the debate about interest rates is—or should be—considered a sideshow. Persistent deficits reduce national saving and therefore hurt the economy even if they do not affect interest rates. regardless of whether interest rates rise. Nor does it matter if the deficit is completely financed by capital inflows. For example, even if capital flows in to offset the deficit, that only implies that domestic production does not fall. But since Americans would own fewer claims on that production, since they borrowed from abroad, their income would still fall.

Fifth, the fiscal problems the country faces are unlike any other the country has faced in their origin and nature. We will likely have to find a new way of dealing with them. The notion that Federal spending can be held to its post-World War II norm of about 18 or 19 percent of GDP seems virtually impossible to maintain without severely cutting the major entitlement programs or eliminating the rest of government. In future years, spending on Social Security, Medicare, and Medicaid alone is anticipated to exceed 19 percent of GDP. The unpleasant implication is that a long-term resolution of these issues that does not destroy the role of the Federal government in American society will have to include significant increases in tax revenues as a share of the economy.

The comments above are documented and elaborated in several recent papers, which are attached to the submitted testimony. The papers include:

Alan J. Auerbach, William G. Gale, and Peter R. Orszag. "Reassessing the Fiscal Gap: Why Tax-Deferred Saving Will Not Solve the Problem." Tax Notes. July 28, 2003. Forthcoming. Available at*http://www.brookings.edu/views/papers/orszag/20030714.htm.*

William G. Gale and Peter R. Orszag. "Fiscal Policy and Economic Growth: A Simple Framework." Tax Notes. February 3, 2003. Available at *http://www.taxpolicycenter.org/ research/author.cfm?PubID=1000450.*

William G. Gale and Peter R. Orszag. "The Real Fiscal Danger." Tax Notes. April 21, 2003.

Available at *http://www.brook.edu/views/articles/gale/20030421.htm.*

William G. Gale and Peter R. Orszag. "Sunsets in the Tax Code." Tax Notes. June 9, 2003.

Available at *http://www.brook.edu/views/articles/gale/20030609.htm.*

Note.—Arjay and Frances Fearing Miller Chair and Deputy Director, Economic Studies Program, Brookings Institution; and Co-Director, Tax Policy Center. Much of this testimony is based on collaborative work with Alan Auerbach and Peter Orszag. All errors and omissions are my own responsibility and should not be attributed to any other individual or organization.

Chairman NUSSLE. Mr. Spratt.

Mr. SPRATT. Thank you, Mr. Chairman.

Mr. Gale, I have to leave to go testify at another hearing, and I simply wanted to thank you for coming and put one question to you, which is the overarching question of this hearing. Given what you have just laid out, given what we know about long-term costs, about the effects of tax cuts, as well, what should we do with respect to the budget to at least ensure awareness that decisions like big tax cuts or big entitlement increases are reflected in our decision making? Or should we go even further and formally factor into the budget its compilation and its presentation, some kind of accrual of these known expenses in the out years, including the big tax reductions as well as big entitlement programs?

Mr. GALE. I have gone full circle on what the right sort of budget rule set of responses are. Two years ago if you had asked me, I would have laid out a very detailed, complete set of rules that I thought would solve every imaginable problem. And then over the past 2 years those rules would have fallen by the wayside. I think there are two problems. One is that government finances are complicated. There is just not a simple way to summarize the activities of the Federal government, which is a fifth of the entire economy. And the second issue is that rules can be broken. And so we want a rule that is simple enough to understand, but strong enough to resist maneuvers to evade the rules. It is very difficult to come up with a single set of rules, I think, that solves all those problems.

So what I think currently, and I hope that my thinking will continue to evolve on these issues as I learn more, is that we need different information for different purposes. It is very unlikely that one single budget is going to provide everybody's answers to every question. For example, we need the cash flow budget simply to keep track of what the government is actually spending and what the government is actually bringing in. We need the CBO baseline to mark what are actually legislative changes and what are not changes. But neither of those provides an accurate picture of the financial status of the Federal government, so we need a variety of supplemental budgets as well, including budgets that project out, for example, the elimination of expiring tax provisions. For reasons that are unknown to me, the budget assumes that temporary spending provisions are extended, but temporary tax provisions are allowed to expire. It would make more sense to make those things consistent, and, given past history, it makes more sense to assume the budget score, the revenue score, that temporary provisions are either treated as permanent or, if they are treated as temporary, then they need 60 votes or something in the Senate, maybe in the House 60 percent, to overcome an extension of that provision.

So I think there are a variety of particular rules that would help, and there are a variety of particular budget presentations that would help, but there is no silver bullet other than eternal vigilance by Congress.

Mr. SPRATT. Thank you very much.

Chairman NUSSLE. Thank you.

I just have a few questions. First is does the tax burden by the Federal government, State government, local government, does tax burden affect the economy?

Mr. GALE. The short answer is yes. The broader question is does the burden of government affect the economy, and the answer is yes, as well as saying that the benefits of government affect the economy too.

Chairman NUSSLE. Yes. Well, let me ask. Does the tax burden affect GDP?

Mr. GALE. Sure. Both the level of taxes and the composition and the incentives created by taxes have effects, both positive and negative, on GDP.

Chairman NUSSLE. As part of GDP, will it affect component parts such as employment?

Mr. GALE. Certainly.

Chairman NUSSLE. Productivity?

Mr. GALE. Absolutely.

Chairman NUSSLE. Does increasing the tax burden have an effect on GDP?

Mr. GALE. Absolutely.

Chairman NUSSLE. Unemployment?

Mr. GALE. Or employment.

Chairman NUSSLE. Or employment.

Mr. GALE. Again, both the level and the composition of taxes will affect the economy. Something that raises revenues, but does it in a way that closes loopholes, will probably have an overall beneficial effect on the economy. Something that cuts revenues, but does it by increasing loopholes, will probably have a negative effect on the economy. So both the level and the structure of the tax system matter.

Chairman NUSSLE. Does reducing taxes have an effect on the economy?

Mr. GALE. Absolutely.

Chairman NUSSLE. I understand you are looking at me kind of like why are you asking me these simple questions, but you might be considered an adverse witness when it comes to some of those basic concepts about what taxes do to the economy. So, before we talk about how much the government has to do and what our obligations are, and anything else, I mean, the bottom line is that the government can impact the economy in either a negative way or a positive way depending on the size of the tax burden.

Mr. GALE. Right. Not just the size, but also the incentives. So, for example, the 2001 tax cut did a couple things. Think of it broadly as cutting marginal tax rates and increasing the budget deficit. Increasing the budget deficit reduces national saving and reduces future national income. Cutting marginal tax rates generally will help increase, to some extent, labor supply, saving, entrepreneurship, etc. The net effect of the tax cut is the sum of the generally positive incentive effects and the generally negative budget deficit national saving effects. And so estimates have suggested that, at least over the long run, the budget deficit effects outweigh the incentive effects, so you get a small negative impact.

Chairman NUSSLE. Long run?

Mr. GALE. Long run.

Chairman NUSSLE. Right. If nothing is done.

Mr. GALE. If the tax cut is implemented as legislated.

Chairman NUSSLE. But if nothing is done, long run.

Mr. GALE. No, no. If you implement the tax cut and let it go forward and extend it, you know, remove the sunsets, estimates suggest that that alone will reduce long-term GDP growth.

Chairman NUSSLE. That alone, absent any other activities.

Mr. GALE. Right.

Chairman NUSSLE. Right. OK.

Mr. GALE. Right.

Chairman NUSSLE. But if there are other activities, such as maybe contracting the size of the government, contracting the obligations on the spending side, that could also have an impact in the same way.

Mr. GALE. Oh, that is true, but contracting the government would have that effect regardless of whether you had the tax cut or not.

Chairman NUSSLE. Wouldn't interest rates also have a pretty dramatic impact on that? I mean, obviously interest rates being low now is a far better situation for a borrower than if they were high.

Mr. GALE. It is true for a borrower it is better. For someone who is getting interest income and living off it, it is not so good to have low interest rates.

Chairman NUSSLE. Right. But they may also be investing in other vehicles other than just a bond that tracks to the interest rates. So, I mean, I understand what you are saying. I think this is pretty basic, but there are some who don't believe it at all.

The other thing I wanted to ask, because it came up before, when government reduces your taxes, just take yourself personally, what happens? I mean, let me lead you in the direction and you tell me if I am wrong. Don't you keep more money? Assuming you don't change, you haven't reduced your salary. Let us assume Brookings keeps paying you a similar amount, maybe they even give you an increase. But the bottom line is that if I don't take as much from you, you get to keep a little bit more, right?

Mr. GALE. That is correct.

Chairman NUSSLE. So there is more money in your pocket, right?

Mr. GALE. Right.

Chairman NUSSLE. Did the government borrow money in order for you to keep more of your money?

Mr. GALE. Essentially, yes.

Chairman NUSSLE. How did that happen? Did I borrow money and then give it to you so you could keep it in your pocket?

Mr. GALE. No.

Chairman NUSSLE. No. You got that from Brookings. Now, let me get to the other part.

Mr. GALE. OK.

Chairman NUSSLE. Did I borrow money to spend? Yes. Did I borrow money because there wasn't enough revenue? Yes. Did I borrow money because we had more obligations on the spending side? Yes. But I didn't borrow any money so that you would be able to keep more money from Brookings.

Mr. GALE. I think Doug Holtz-Eakin's answer about the accounting is the one I am going to give.

Chairman NUSSLE. No, no, no. I want your answer.

Mr. GALE. Well, I am going to give you the same answer, which is that the deficit is the difference between taxes and spending.

Chairman NUSSLE. Oh, I understand that.

Mr. GALE. If you reduce taxes, the deficit goes up.

Chairman NUSSLE. I understand that.

Mr. GALE. It is sort of like asking which side of the scissor does the cutting. You know, it is just an accounting identity.

Chairman NUSSLE. That is true in Washington, what side of the scissor does the cutting. I am talking about you now, and I am talking about any other taxpayer. Let me finish. I will give you an opportunity. Let me finish.

Mr. GALE. OK.

Chairman NUSSLE. If Brookings pays you the same amount of money and I reduce the amount of money you are sending to me, how did you get that money, was it borrowed from the government? No. It was given to you by the Brookings Institute for the value of the occupation, the value of the services that you provided to Brookings. Isn't that correct?

Mr. GALE. In some literal sense, yes; in any realistic economic sense, no.

Chairman NUSSLE. Who did you get your money from?

Mr. GALE. The value of thinking about this as an economic perspective is that it forces you to add up all the various parts, and you can look at the effect on me directly, the tax cut will have a direct effect on my after-tax income, but it will also have effects that ripple through the economy that then affect the prices that I pay for things, and the interest rate that I pay to borrow, and the burdens that are placed on my children, etc. So, I mean, it is almost like at the level at which your statement was right, I could say, well, no, Brookings doesn't pay me, the payroll company pays me, because they are the one that send the check. Alright? But in an economic sense the government is reducing its revenue, but holds its spending constant, it is therefore borrowing more and, therefore, the money that is coming to me is being financed by the increase in borrowing.

Chairman NUSSLE. I understand what you are saying, and this is, I suppose, and the way you are answering it particularly as an economist, a chicken or egg kind of a theory, what comes first. But from my perspective what comes first is you in your job. I mean, I don't get to take any money from you at all, period, if you don't have a job, do I?

Mr. GALE. That is correct.

Chairman NUSSLE. Well, that is, I guess, the point, is that what comes first to me, and why I said in Mr. Cooper, with his two degrees from wherever he got them from in the economist, and that is great, I respect that greatly, I respect your degrees, but my point is in the economic model that starts this whole thing going, if you don't get a job so that you can make money, so that I can take some of it to come out here and complete the rest of the transaction, it doesn't work.

Mr. GALE. It is fair enough to say that ultimately the issue is the economy and that the right debate to have is what is the best way to have a healthy economy.

Chairman NUSSLE. Thank you.

Mr. Scott. Sorry to take so much time.

Mr. SCOTT. No problem.

Thank you, Mr. Gale. I had a little problem, as you did, trying to follow the logic. Let me ask you another question. Did Federal government borrowing increase as a direct result of the tax cuts?

Mr. GALE. Absolutely.

Mr. SCOTT. Thank you.

I put back up the chart that I started off with to respond to my friend from Connecticut who was blaming this side of the isle for spending increases and projections. I just want to remind everyone that on that chart Democrats voted against the red and for the green. Democrats voted for the green and against the red. So that was our plan. The green is the Democratic plan; the red is the Republican plan.

Chairman NUSSLE. Would the gentleman yield on that? Can I just ask a basic question?

Mr. SCOTT. Yes..

Chairman NUSSLE. We will check the record, but have you voted for any appropriation bills yet this year?

Mr. SCOTT. I have voted for appropriations. I have proposed spending. But the fact that those who voted for the red part of the budget does not disqualify me from participating in helping to the priorities of the government. But I remind you that when we were in control and President Clinton was providing the leadership, you look at the chart, the green.

Mr. SCHROCK. Would the gentleman yield?

Mr. SCOTT. I will yield.

Mr. SCHROCK. And I appreciate it, because I realize there are more Republicans in this room, so we are not looking to gang up here.

Chairman NUSSLE. He can take us all on, trust me.

Mr. SCHROCK. I know that. But I wanted to give the impression that he couldn't. But when I look at the Reagan-Bush years, I do remember the Democrats were in control during some of those times, and they were Democrat budgets, and the deficits were going up. And I kind of look at the Clinton years with Republicans and say, you know, we kind of were the ones encouraging that we get our country balanced again. So I kind of then say maybe we are both kind of mixed up in it. So I wasn't putting all the blame on the Democrats.

Mr. SCOTT. Well, let me just say that, if you look at the budgets, the overwhelming number of votes on the red came from the Republican side. And when the Clinton administration was controlling the budget, essentially it was the Clinton budget. The first 2 years he had a Democratic Congress; the next 2 years he had the veto trillion dollar tax cut several times, in fact, vetoed those tax cuts in the face of a threat to close down the government. The government was shut down, he vetoed them again.

Mr. SCHROCK. He vetoed our spending budgets.

Mr. SCOTT. He vetoed your budgets. He vetoed your tax cuts. You went in with a trillion dollar tax cut; he said no; you closed down the government and he vetoed it anyway.

And then the difference in the red under Bush II is that you passed the trillion dollar tax cut and he actually signed it. Look what happened.

Mr. SCHROCK. Would the gentleman yield one more time? And then I will not interrupt him again.

Mr. SCOTT. I will yield.

Mr. SCHROCK. We had a shutdown in December; they were on four appropriations budgets. They weren't on any tax bill, they were on appropriations. And the president vetoed them because he said we weren't spending enough. And the only way that we were able to get an agreement was that we spent more.

Mr. SCOTT. I think if you look at the Clinton years, President Clinton controlled the budget process and you got green. As soon as Bush could sign some of the budgets, you got red.

And let me get to some other questions I had.

Mr. Gale, you are familiar with what happened after the tax cuts were enacted: the job situation collapsed. And I think we had a little trouble following the actual projections.

This is a chart showing the Joint Committee on Taxation projection of what happens if you pass the 2003 tax cut, that you have a little short-term spike in jobs, but long-term the best you can hope for is that you come out even. Most of the projections and models show that you can end up worse than you started as a direct result of passing the tax cut. Is that right?

Mr. GALE. That is right.

Mr. SCOTT. Now, some tax cuts are better than others in terms of stimulating the economy. Based on the ones we had, passage of the 2003 tax cut was a long-term job killer, is that right?

Mr. GALE. That is certainly what the JCT study found in its analysis of dynamic scoring.

Mr. SCOTT. And that has a Republican majority.

Now, we heard from the previous speaker the Medicare next 10 years, second 10 years, going at a trillion dollars; interest in the national debt $500 billion a year; we have got obvious sunsets that are going to be removed; ATM fixes and whatnot will be hundreds of billions of dollars; and we saw the Social Security trust fund with a massive shortfall. Is there any credible expectation that we can pay Social Security in the future without a fundamental change in direction?

Mr. GALE. Something has to give. We can dispute the basic long-term figures about how big each of these components are, how big the total is, but it is evident that we are on a path right now that is unsustainable. How that gets resolved is up to you all, obviously, but something has to give, yes.

Mr. SCOTT. Unsustainable means you can't continue increasing the interest on the national debt and cutting taxes the way the taxes have been cut. With those lines going the way they are going, you can't credibly expect to be able to pay Social Security and Medicare in the future without a fundamental change in direction.

Mr. GALE. That is right. Either you will have to impose very large cuts in the entitlement programs or essentially eliminate the rest of government, the discretionary side, or raise tax revenues by a significant amount. But there is no other way out. It is possible conceptually that we could grow out of the problem, but no one has any idea how to stimulate the incredibly massive amount of growth that we would need to actually grow out.

Mr. SCOTT. Well, let us get a couple of number on the table. The on-budget deficit this year is about $600 billion, is that right?

Mr. GALE. The on-budget.

Mr. SCOTT. On-budget deficit.

Mr. GALE. I think, roughly speaking, that is right, yes.

Mr. SCOTT. What we get from the individual income tax every year is about $800 billion.

Mr. GALE. That sounds right. It might be a little more.

Mr. SCOTT. I have been told $790 billion.

Mr. GALE. OK, a little less.

Mr. SCOTT. About $800 billion. So that is how far out of balance we are.

Mr. GALE. Right.

Mr. SCOTT. That wasn't a question, Mr. Chairman, that was a statement. I appreciate the witness.

Mr. GALE. Just briefly, the long-term fiscal imbalance that I have estimated and that other people have estimated is roughly 7 percent of GDP. That is about a third of Federal spending. So basically you either need to cut spending by a third or raise taxes by a third to bring the situation back into long-term balance.

Now, again, the exact number is subject to debate, but whether it is a fifth or a third or a half, it is a monstrous adjustment in the public sector.

Chairman NUSSLE. Thank you.

Mr. Shays.

Mr. SHAYS. The scary thing is when the chairman was asking questions about taxes in your income, I actually understood him. And I know the point he was making; I thought he made it brilliantly, frankly. Would you advocate increasing taxes equal to the deficit?

Mr. GALE. Currently? Which deficit, the current deficit or the long-term deficit?

Mr. SHAYS. No, no, the short-term. Next year. The deficit is whatever it is going to be, $450 billion, $500 billion. Should we increase taxes $500 billion to eliminate the deficit?

Mr. GALE. Let me answer that in two parts, alright? And I will take your "Profiles in Courage" challenge here.

Mr. SHAYS. I mean, isn't the simple answer obviously not?

Mr. GALE. No. The simple answer is not obviously not.

Mr. SHAYS. OK.

Mr. GALE. The deficits that matter for the long-term status of the economy are the long-term budget deficits. If we had a deficit of $450 billion this year, and then we had surpluses as far as the eye could see, no one would care about this year's deficit. So it is not this year's deficit that is the long run threat. The long run threat, again, is the termites in the woodwork gnawing away gradually at the economic infrastructure. That is the deficit problem that needs the most attention. And that is the deficit problem that could be fixed with a significant increase in the long-term share of taxes as part of the economy, that is, by long-term tax increases, and I think that that is an issue that has to be on the table.

The current deficit actually helps stimulate the economy in the short run for the same reason it hurts in the long run. There is a difference between stimulus and growth. Stimulus is like drinking a can of Coke, it gives you a big sugar and caffeine rush, and you can get more out of your existing body; you can get more energy out of your existing body. Growth is strengthening your muscles and bones, and building a better body. OK? So the short-term deficits right now are sort of No-Doze for the economy, if you will, but, as you know, if you take No-Doze long enough, you are in pretty bad shape.

And so I don't know that we have to eliminate the short-term deficit this year. I wouldn't particularly advocate that. I would suggest that it is not a wise idea to continue digging the hole deeper.

Mr. SHAYS. So the real issue is how quickly does the economy grow. And the reason why you wouldn't increase taxes a lot this year, as you know, it would have a tremendously harmful effect on the economy. And what you know as an economist is that even if we did not have a tax cut, we would still have a deficit of $275 billion, with no tax cut. I mean, that is a fact, true?

Mr. GALE. I think that is right, yes.

Mr. SHAYS. So your lesson to me is this economy better grow, or else we are going to have a big problem; and there you and I agree. And so then the next issue is you would be saying to us that what we have done is not going to encourage growth; and if you are right, then we have got a big problem. And time will tell whether we are encouraging growth, and that is the issue that I am interested in right now.

Mr. GALE. Well, time will tell, that is true. On the other hand, after a great brouhaha about introducing dynamic scoring, the JTC finally did dynamic scoring and showed that the "Jobs and Growth Act" will have a negative effect on jobs and growth in the long run, and the reason is the way you stimulate the economy in the short run is very different from the way you make the economy grow in the long run. In the short run, with the huge amounts of excess capacity and businesses not wanting to invest because there is no aggregate demand out there, the way you get the economy stimulated is to boost aggregate demand; and one way to do that is to run budget deficits. In the long run, you need to increase the capacity of the economy, and that is where the negative effects of budget deficits come in, because they sap capital from the private sector. So in the long run sustained deficits are going to hurt the economy, and that is why we need to raise taxes, in the long run, to reduce the negative effect on the capital stock.

Mr. SHAYS. Yes, but in the long run, as we have looked at our charts and as you have seen, it is the rising spending burden.

Mr. GALE. Well, again, this is the two sides of the scissors. Just to say that spending is bigger than taxes doesn't mean that spending is too high.

Mr. SHAYS. May I finish my point?

Mr. GALE. Certainly.

Mr. SHAYS. And then you make your point. You interrupted me and I wasn't able to make my point.

Mr. GALE. Sorry.

Mr. SHAYS. And my point was very simply that you are so focused on the taxes, and I am intrigued with why, when you look at the per capita spending of Americans going up to almost $6,500, why you don't think that will have a negative impact on the growth of our economy. And when you see Medicare, Medicaid, and Social Security growing at the rates they are going to grow, that scares the heck out of me, and you haven't counseled us at all on finding ways to slow the growth of them; you have solely focused on taxes. And I would have a lot easier time accepting your argument if the entitlements were part of your message, and I am curious why they aren't.

Mr. GALE. I certainly did not mean to imply that entitlements are not part of the issue. I think the first thing I said was the conventional wisdom is accurate: the United States faces substantial projected fiscal deficits in the coming decades. A big part of the reason why is that increasing life spans, retirement of the baby boom, and changes in health care technology will generate persistent increases in spending on Social Security and Medicare.

Mr. SHAYS. And then the rest of your whole dialogue has totally been on taxes. The whole dialogue.

Mr. GALE. Well, the effort here is to provide value added. I think you have already heard endless times that Social Security, Medicare, and Medicaid are part of the problem. One of my points was to say that the tax issues that we discuss everyday are very large relative to the long-term issues that we always talk about.

Mr. SHAYS. I just conclude by saying, Mr. Chairman, that I don't really think we heard that even from the previous speaker, at least in the response to questions.

But I am not going to argue with your basic point, that there has to be some limit to the amount of tax cuts you can have, but in the same way there is some limit to the amount of tax increases you can have as well. And I thank you, I think you have been a very interesting witness. Thank you very much.

Mr. GALE. OK, thanks.

Chairman NUSSLE. Mr. Diaz-Balart.

Mr. DIAZ-BALART. Thank you, Mr. Chairman.

You obviously are concerned about deficits, as I am. Would it be a fair statement that if I had a proposal to increase, I don't know, the long-term deficit by a trillion dollars, you wouldn't be really keen on that, right? I mean, I should probably not file that legislation?

Mr. GALE. Again, it depends on what you are doing with the money. Deficits, per se, are not good or bad. Let me take that back. Policies that create deficits, per se, are not good or bad; they have two sets of effects. One is their direct effect on the economy and the second is that their indirect effect via increasing the budget deficit.

Mr. DIAZ-BALART. I understand that. But you just spent a long time now talking about, and I, frankly, in some ways agree with you, concern about the deficits. So now is there a caveat as to the deficit not being bad?

Mr. GALE. No, no, no, no.

Mr. DIAZ-BALART. Alright. My question is, if I had a bill that increased the deficit by a trillion dollars, or let us say it is less, let us say it is $500 billion, to increase the deficit, you don't think that would be a really good idea.

Mr. GALE. I would say that aspect of the bill would have negative long-term economic repercussions, but the overall effect of the bill would depend on the direct effect, which you haven't told me about, plus the indirect effect.

Mr. DIAZ-BALART. Of course. You have been focusing on the deficit, and I think we need to focus on the deficit, and I think the majority party is clearly focusing on the deficit. One of my concerns is that the minority, and they have the right to do so, their proposals increase the deficit by almost $900 billion. And if we are concerned by the deficit, which, by the way, you don't have to be, but if we are concerned about the deficit, as I am, I think clearly an increase of almost a trillion dollars a long-term in the deficit is problematic, and I think no ifs, ands, or buts, whether we do good things to increase the deficit by another trillion dollars. I am not talking about the deficit that you are concerned about, I am talking about that plus another trillion dollars. I think we could all agree that that would be problematic.

But one of the things that you mentioned a little while ago, which I thought that I agree with you, was your concern about obviously cutting waste whenever you can. And so I imagine that you would support cutting waste whenever that is possible. You mentioned that, is that correct? I want to make sure I am not putting words in your mouth.

Mr. GALE. I do support cutting waste, yes.

Mr. DIAZ-BALART. Mr. Chairman, so do I, which is why I am always kind of in awe as to why, when our colleagues in the minority party, we didn't get one vote—not one vote to cut just 1 percent in waste, fraud, and abuse. Not one vote to cut waste, fraud, and abuse from members of this committee or on the floor from our dear friends on the Democrat side, when we know that waste, fraud, and abuse is rampant.

Let me just also ask you another question.

Could we put up chart 3? Do we have that? If not, we won't put it up, of course.

Without the tax cuts, we would have another 1.8 million people unemployed. 1.8 million people unemployed. Forget about theories now. Can you tell those 1.8 million people that their jobs are not important and, therefore, we should have not done that stimulus package that the President and the Congress passed? Do you think if you were one of those 1.8 million people and we couldn't be talking about whether your salary was paid for by, in theory, if you were one of those, do you think it would be OK to just say we shouldn't have done it? Can you look at those American hard working people and tell them that the policies were not worth it because their jobs are not that important?

Mr. GALE. I would say two things. One is I don't know where the 1.8 million number comes from. The numbers I have seen in the calculations I have done are substantially smaller than that.

Mr. DIAZ-BALART. Can you tell those people that have gotten their jobs that their jobs are not important?

Mr. GALE. Let me finish.

Mr. DIAZ-BALART. If you would answer my question. I would like you to answer my question.

Mr. GALE. Yes. I am trying.

Mr. DIAZ-BALART. My question is can you tell them that their jobs are not important and that we shouldn't have done that.

Chairman NUSSLE. Let us let the witness answer.

Mr. GALE. What I would tell them is their job is important, and that we could have gotten those jobs in a much less expensive, less regressive manner than the tax cuts that we passed the last 3 years. Every study of the short-term effects, stimulus effects, suggests that tax cuts that were aimed lower in the income distribution and aid that had gone to the States would have provided bang for the buck, that is, jobs per dollar cost, that is substantially larger than large-scale tax cuts for high income households. And, you know, you can look at virtually any of the major consulting firms that are out there, any of the logic of the major macro economic models will tell you that. So it is not a matter of anyone being opposed to 1.8 million people getting jobs; it is a matter of the fact that the way we got those 1.8 million jobs imposes unnecessary burdens on my children, all of our children, and imposes or creates a distribution of after-tax income that I think a lot of people don't think is fair.

Mr. DIAZ-BALART. And thank you again for your testimony. My final point is that what I have learned, I have a sister-in-law who is an economist, and she has always told me that they can pretty much confuse relatively simple issues. What we have heard today is that deficits are a huge problem, and yet when the minority wants to increase the deficit by a trillion dollars, $900 billion, to be correct, $890 billion, it looks like the problem is not the deficit, it is who proposes the deficit. And then when we hear that jobs are important, but if a Republican proposal created the jobs, that seems to be a problem. As far as I am concerned, there is 1.8 million people that have jobs that wouldn't have it. I cannot look at those people in the face and tell them their jobs are not important.

Mr. SCOTT. Mr. Chairman. Mr. Chairman.

Chairman NUSSLE. The gentleman from Virginia.

Mr. SCOTT. Would the gentleman yield?

Mr. DIAZ-BALART. With pleasure.

Chairman NUSSLE. He doesn't have the time.

Mr. SCOTT. Could I make a comment just very briefly?

Chairman NUSSLE. If you do it briefly. Then I need to recognize Mr. Hensarling.

Mr. SCOTT. Thank you. I would point out that this chart ends at 2003, and perhaps the witness could explain what would happen in a few years and who would be explaining what to who if this chart went out to, say, 2013, payroll jobs with and without the tax cuts.

Mr. GALE. Sure. This comes back to the stimulus being the can of Coke; you get your sugar rush and you feel like you have more energy, but then it wears off and you feel more tired. The same thing will happen with these tax cuts; and this is even according to the Joint Committee on Taxation dynamic analysis, it is according to the Congressional Budget Office's analysis of the President's budget and so on. What you get in these tax cuts is short-run Keynesian stimuli, which then turn into long-run drags on the economy. And the benefits of the short-run Keynesian stimuli are certainly there, but the point, the relevant critique, is that the same benefits could have been obtained in a less expensive, less regressive manner, and with lower long-term costs in terms of the feedback effects on the capital stock. So ultimately there are going to be fewer jobs, according to CBO, 10 years out because of these tax cuts.

Chairman NUSSLE. Mr. Hensarling.

Mr. HENSARLING. Thank you, Mr. Chairman.

Well, Dr. Gale, I think I have good news: I appear to be the last questioner of the day. Unfortunately, I missed a portion of your testimony, but if I read it correctly, you claim that tax relief is the real fiscal danger, if I read that correctly in your testimony.

My review of economic history shows that in the 1980s, when we had significant tax relief, that we promoted real economic growth of 3.2 percent between 1981 and 1989, and tax revenues grew. During the 1960s we had significant tax relief and real economic growth averaged 5 percent for 7 years and tax revenues grew. During the 1920s we had significant tax relief and real economic growth averaged 4.7 percent and tax revenues grew. I have seen these statistics in a wide variety of economic tests, so my two-part question is, No. 1, do you doubt the validity of these facts and, if you do, do you assume that there is no relation to the burden of taxation and economic growth?

Mr. GALE. I certainly do not assume that there is no relation between economic growth and tax policy. If I did assume that, about half of what I do I would no longer do.

Let me just comment briefly on this. Think about tax cuts as having two sets of effects: there is the direct effect on the economy of the incentives that are provided and there is the indirect effect on the budget deficit. OK? So the direct effect, let us call that positive. It may not be, but let us call it positive. The indirect effect on the budget deficit is definitely negative.

Mr. HENSARLING. Well, I am sure, but since I have a limited amount of time, are you agreeing, then, with the facts that I have posited?

Mr. GALE. No.

Mr. HENSARLING. OK, please continue.

Mr. GALE. I am disagreeing with the interpretation of the facts. OK? Everyone can look up economic growth rates by decade. I am not disputing the data.

Mr. HENSARLING. So you are disputing the cause and effect.

Mr. GALE. Yes.

Mr. HENSARLING. You will admit there was significant tax relief and that economic growth grew significantly afterwards, you are just debating the nexus, is that correct?

Mr. GALE. Economic growth continued afterwards. In the 1960s, for example, the growth rate in the 2 years before the tax cut was just as high as the growth rate in the years after the tax cut. In the 1980s, if you look at the 1980s in historical perspective, we did not get that much growth relative to other decades, it is just we had such a bad recession at the beginning that it felt like we did.

Mr. HENSARLING. OK. Well, as I understand it, then, you doubt the nexus or you doubt my interpretation of the economic data, but you admit some nexus between tax relief and economic growth.

If I could, let me move on, since you stated that tax relief is the real fiscal danger.

Mr. GALE. I think I said it deserved equal billing as the real fiscal danger.

Mr. HENSARLING. OK, I am sorry, I missed a portion of your testimony. Equal billing to what?

Mr. GALE. With Social Security and Medicare.

Mr. HENSARLING. With Social Security and Medicare.

We passed in the House a $350 billion economic growth package over 10 years, and that is contrasted with a $28.3 trillion—trillion with a "T,"—budget. And if I am doing my math correctly, $350 billion to $28.3 trillion is approximately 1.2 percent. If we round off, doesn't that seem to suggest that when it comes to deficits, that 99 percent of the real fiscal danger is on the spending side, and not the tax relief side, which you have already admitted may have some connection to positive economic growth?

Mr. GALE. The short answer is no. This gets back to the whole problem with the Federal budget in the way we account for various programs. The three tax cuts that have been passed since 2001, if they are made permanent, as the President, the Vice President, all the economic advisors, and all the congressional leaders of the Republican party in both Houses have suggested they want, would cost 2.3 percent of GDP in revenues.

Mr. HENSARLING. Forgive me for interrupting.

Mr. GALE. The Social Security trust fund is a third of that.

Mr. HENSARLING. I understood your short answer was no, that you disagree that 99 percent of the spending is the problem. In the remaining time I have, since these hearings do deal with waste, fraud, and abuse, this committee has heard testimony before that HUD has spent almost 10 percent of their budget in payments to people who don't qualify for the program. Approximately 25 percent of the people who have their student loans under the Department of Education forgiven for disability actually hold full-time jobs. Approximately 10 percent of food stamps are issued to people who don't qualify. Approximately 30 percent of the people who receive the earned income tax credit do not qualify. Might that suggest, if we are scratching the surface, that if we routinely are wasting 10, 20, and 30 percent of the taxpayers' money in these government programs, is it not possible that waste, fraud, and abuse in Federal spending also represents a real fiscal danger?

Mr. GALE. I think qualitatively the answer is yes. In terms of the dollar magnitudes, the answer is probably no. Ten percent of food stamps is a pretty small number compared to Social Security, Medicare, and Medicaid spending. But having said that, I would encourage you to root out waste, fraud, and abuse both on the spending side and the tax side. The tax evasion numbers I think are equally substantial, and all of that is obviously appropriate jurisdiction of government policy.

Chairman NUSSLE. I thank the gentleman. We will be having that hearing in the near future on taxes and our tax code. Today was to talk a little bit more about the long-term obligations, as opposed to the tax side. But you do make a good point, at least in my opinion.

Mr. GALE. Thank you very much.

Chairman NUSSLE. I thank the gentleman.

We will be having that hearing in the near future on taxes and the tax code. Today was to talk a little bit more about the long-term obligations as opposed to the tax side. You do make a good point, at least in my opinion, on the tax code and the need for reform and loophole closing. I think many of us would agree with that.

This has been spirited. We appreciate it. You are a good sport, you always have been. We appreciate that and we appreciate your testimony before the committee again today.

Mr. GALE. Thank you very much.

Chairman NUSSLE. Thank you.

If there is no other business to come before the committee, we will stand in adjournment.

[Whereupon, at 12:25 p.m., the committee was adjourned, to reconvene at the call of the Chair.]

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